The Canadian Chartered Accountant

OFFICIAL ORGAN OF

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

Published monthly; subscription $3.00 per annum in advance; single copies thirty-five cents. Advertising rates sent on request.

Articles submitted for publication will be read as promptly as possible, and either retained for use or else returned to the author.

Opinions expressed in articles in The Canadian Chartered Accountant are not necessarily endorsed by the Association.

Authorized as second class mail, Post Office Department, Ottawa.

Publication Office
10 Adelaide Street East, Toronto
R. F. BRUCE TAYLOR, Editor

VOL. LI — JULY 1947 — ISSUE NO. 1

Editorial Comment

Comments on Current Practice

In this issue, we are including the first of what we hope will be a series of interesting and provocative notes on "Comments on Current Practice" prepared by Clem L. King, C.A., Secretary and Director of Research of the Association. The topic discussed this month is "Reserves" and comment from readers is cordially invited. Mr. King will prepare similar memoranda from time to time on other subjects as they occur to him and suggestions as to topics will also be welcome. As pointed out in the Editor's note at the head of the item, these are to be considered as quite unofficial and merely as a basis for discussion.

Coming D.A.C.A. Annual Meeting

The formal notice and also the draft programme of the Dominion Association of Chartered Accountants' annual meeting to be held in Vancouver in September are printed in this issue. It is hoped that there will be a good attendance representative of all parts of the Dominion. The Institute of Chartered Accountants of British Columbia is in charge of the arrangements and is arranging an attractive series of social events.

Reserves

While on the subject of Reserves, the annual accounts of the Toronto Transportation Commission as at December 31, 1946 have just come to hand. Granted that this is a public utility and perhaps a special case to which ordinary accounting principles may not apply, is there really any justification for the following grouping of "Other Reserves"?—

For Redemption of Outstanding Tickets	$ 429,131.65
For Workmen's Compensation and Public Liability	1,768,378.42
For Foreign Exchange	567,137.29
For Rehabilitation and for Modernization and Expansion of the System	12,650,000.00
For Contingencies	3,800,007.93
For Revenue Stabilization	3,100,000.00
	$22,314,655.29

The first two items may perhaps be considered as direct liabilities, the last four are clearly, with the possible exception of some small part of the Reserve for Contingencies, appropriations from Accumulated Surplus Account which stands at $4,571,539.94, and in our view these four items should have been grouped with it. There is, in our mind, no justification from the accounting point of view for the setting up of the fourth or sixth items as accounts separate from Accumulated Surplus or from a close grouping with it. In his report, the General Manager admits that the Reserve for Foreign Exchange is not now required but "due to the future position of Foreign Exchange it is considered prudent to leave this reserve intact".

The Charm of Canada

We have been intrigued by a formal notice in the Canada Gazette of May 17, 1947 that "Charm of Canada Limited" is making application to the Secretary of State for the acceptance of the surrender of its charter. We think that it is going a little too far when the trusteeship of such a valuable, natural (wholly natural!) resource of our great Dominion is vested in the hands of individuals who use it for a selfish purpose and then abandon it. What would our friends to the south of us think of such a bandying about of a national asset? We think the Secretary of State should not have permitted the use of this name to

start with, and that, having done so, he now should require a change of name prior to the formal surrender of the charter. We rather hesitate to suggest that possibly our lady members have a greater particular interest here than the rest of us. It would be quite appropriate for them to circulate a petition for presentation to the House of Commons, but we warn them that, due to recent rulings by Mr. Speaker, the precise wording at the beginning and the closing of the petition is considered to be far more important than its general purpose or content.

Taxation Notes

Deferred Maintenance and Repairs

P.C. 2163 dated 29th May 1947 revokes order-in-council P.C. 1502 which fixed the period for the purposes of Section 5 (1) V of the Income War Tax Act. The amendment to the Income War Tax Act states that P.C. 1502 "shall be deemed not to have come into operation or to have been made." and that the period is to be a twelve month period "ending not later than the thirty-first day of December, 1950, to be fixed by the Governor in Council."

Standard Profits Claims

In the budget resolutions the Minister of Finance proposed that no taxpayer should be entitled to make application for determination of his standard profits on or after 1st August 1947. Directive 17 issued by the Deputy Minister of the Taxation Division was issued on this assumption. However the amendment to the Excess Profits Tax Act provides that such applications may be filed up to 31st August 1947, an extension of one month beyond the original proposal.

The Dominion Association of Chartered Accountants

Notice of Annual Meeting

THE forty-fifth annual meeting of the Dominion Association of Chartered Accountants will be held in Vancouver, British Columbia, at the Hotel Vancouver, on Monday to Friday, September 8 to 12, 1947, for the reception of reports and other business.

The Council of the Association will meet on Monday, September 8, and on September 9 and 10. The Executive Committee will meet on Monday, September 8 and on September 10. General sessions of the members will be on September 10, 11 and 12.

Details are given in the draft program printed elsewhere in this issue.

Notice has been received by the secretary of a proposed amendment to by-law No. 3, of the Association to be effective as from 1st June 1947, whereby the fees payable to the Association by the Institutes in respect of each of their members shall be increased from $7.00 to $10.00 per year and from $3.50 to $5.00 in respect of new members coming on the rolls in the second half of the fiscal year. The by-law, as amended, would then read:

> "3. Each of the Institutes shall pay to the Association an annual fee of $10.00 for each of its members in good standing (other than honorary members, in respect of whom no annual fee shall be payable), provided that for a new member who is a member for not more than six months of the first year the fee for that year shall be $5.00. If a person be a member of more than one institute the annual fee shall be paid by the institute of which he first became a member."

RICHARD C. FIELD
President

CLEM L. KING
Secretary

Toronto, Ontario. 2nd July, 1947.

Draft Program Annual Meeting

Vancouver, B.C., September 8-12, 1947

COUNCIL AND COMMITTEE MEETINGS

Monday, September 8

9.30 a.m.	Executive Committee
12.30 p.m.	Dominion President's Luncheon for Council
2.30 p.m.	Council

Tuesday, September 9

9.30 a.m.	Committee on Education and Examinations
12.30 p.m.	British Columbia President's Luncheon for Provincial Presidents and their Ladies
2.30 p.m.	Council

Wednesday, September 10

4.30 p.m.	Council
5.00 p.m.	Executive Committee

GENERAL SESSIONS AND SOCIAL FUNCTIONS

Tuesday, September 9

9.00 a.m.	Registration
8.00 p.m.	Reception

Wednesday, September 10

10.00 a.m.	General Session (Papers arranged by Committee on Accounting and Auditing Research)
12.30 p.m.	Members' luncheon with speaker
2.30 p.m.	General Session (President's report and general business)
2.30 p.m.	Sightseeing tour for Ladies
8.30 p.m.	Informal evening—Royal Vancouver Yacht Club

Thursday, September 11

9.30 a.m.	Golf
10.30 a.m.	Cruise to Howe Sound
7.30 p.m.	Dinner and dance (Informal)

Friday, September 12

10.00 a.m.	General Session: "Recent Accounting Developments in the United States" — Carman G. Blough, Director of Research of the American Institute of Accountants.

A reply card has been mailed to members and, because of the demand for hotel accommodation, it is essential that all those who plan to come should return their cards as early as possible, in any event not later than 31st July.

Confirmation of hotel accommodation will be sent in advance of the meeting.

Financial Statements for Corporate Annual Reports

By W. Blackie

Recent financial statements of Caterpillar Tractor Co. contain many innovations in form and terminology. This article explains some of the thinking behind the development of these statements and invites comment and criticism. The author, who joined Caterpillar in 1939, following extensive experience in public accounting, is a vice-president of that organization. He is a former vice-president and director of the National Association of Cost Accountants and a member of the American Institute of Accountants.

Introduction

THIS ARTICLE presents a summary of the considerations underlying the form and terminology of the financial statements of Caterpillar Tractor Co., as contained in the company's Annual Report for the Year 1946, and is based upon addresses delivered before the American Accounting Association, September 6, 1946, and the Illinois Society of Certified Public Accountants, December 17, 1946. These addresses were prompted by the fact that innovations in the company's financial statements, particularly in 1944, had attracted considerable attention and had been acknowledged as an influence upon revised forms of financial statements adopted by other companies in their annual reports. This being the case, it seemed appropriate to make public the thinking behind the actions of Caterpillar Tractor Co., thereby providing opportunity for those who may wish to disagree, to agree, or preferably, to improve upon the efforts of that company.

In this way there may perhaps be better developed a greater uniformity of expression among reporting companies to the end that financial statements which purport to convey approximately the same type of information do so in approximately the same way. The general reader of such statements should not be confronted with major differences of form or terminology which do not reflect material divergencies in substance; and although Caterpillar Tractor Co. is itself creating some of these present differences in form and terminology, it is doing so in a sincere belief that the purposes of financial statements can be

Reprinted from The Journal of Accountancy, March 1947.

better served by some departures from traditions which do not seem to have been conspicuously successful. It is hoped that other companies and their professional accountants will go on to develop the subject further in that community of interest which is so conducive to evolutionary progress.

Grateful acknowledgment is made to the independent public accountants and to George O. May for their helpful interest in these efforts to carry out a thought which Mr. May himself had well expressed many years ago: "There is no need to revolutionize or even to change materially corporate accounting; but there is room for great improvement in the presentation of the conclusions to which accounts lead. The aim should be to satisfy (so far as is possible and prudent) the investor's need for knowledge, rather than the accountant's sense of form and respect for tradition".

Historical Background

In accordance with the by-laws of Caterpillar Tractor Co., it is a duty of the directors "to present at each regular annual meeting of the shareholders, a full statement or statements showing in detail the assets and liabilities of the corporation and generally the condition of its affairs". With these words fresh in mind the company's first annual report, for the year 1925, presented (1) a balance-sheet with independent accountants' opinion thereon, (2) about 500 words of comment, and (3) a list of the directors and officers. It complied fully with the spirit and intent in which the by-laws were written, and it was typical of the times.

In reporting for the year 1929, when the company had acquired a few years of background, there were added to the report (4) an historical summary of the balance-sheets at the end of each year, (5) a comparative statement of income and expense, (6) an analysis of surplus account since inception, (7) a dividend history, and (8) a listing of the gross addition to plant and equipment during each year. This was the first time stockholders had been given an opportunity to see a statement of operations or to reconcile the changes in surplus account from year to year. The merits of such a development were, however, quickly apparent in that hectic time of economic readjustment when the lights of past experience were needed as marks,

if not to guide us, at least to tell us how far we were drifting. Each year thereafter the historical summaries were expanded to include another year; but until 1937 the reports remained somewhat terse and visually rather unattractive.

By 1937 business was again on the upgrade, but the intervening depression years had brought about many changes. The greatest of these was, perhaps, in the mode of thinking of a large proportion of the population which had either suffered from economic distress or from the fear of it. In such circumstances there was naturally some doubt about the efficiency of the enterprise system as we had known it and in such a state of mind there were fertile opportunities for the culture of new ideas which might somehow seem to promise something better. In economic thinking there developed, on a larger scale than ever before, the idea of economics as a cause as well as an effect.

When, in 1776, Adam Smith made his *Inquiry into the Nature and Causes of the Wealth of Nations* he had as an objective the finding of means whereby that wealth could be increased. Free trade, competition, and a minimum of government seemed to him to offer the best opportunities. Since then, economics has been mainly concerned with the study of what was happening in the present, in the light of what had happened in the past, as a means of estimating what might be likely to happen in the future, and with attempts to rationalize economic phenomena into principles which might perhaps permit of more reliable deductions. In the severe depression of the 1930's it was, therefore, very natural that there should emerge a revitalized curiosity as to whether the art of economics might not be developed into a tool which might help to keep the economic system in better running order. And so there developed a further expansion of the idea that man might become master of his economic destiny if he could shape the course of events rather than be shaped by them.

The idea, of course, is one which should be pursued—and maybe some day progress will be recorded. The missionaries who had been saving us from ourselves had (and have), however, left us, not only with all the old troubles, but also with some new ones. With the first good prospect of a return to better times, there arose a tidal wave of labor disputes. In 1937, for the first time in its history, the oper-

ations of Caterpillar Tractor Co. were shut down by a strike.

In the battling out of these labor disputes, on both the national and local fronts, the employee became the target of a verbal barrage which hit from all directions. Labor's main objective was organization, and it fired with a rifle while industry spattered back with the less penetrating buckshot of economic fact. In the words of one Josh Billings it became apparent that: "It ain't ignorance that causes so much trouble; it's folks knowing so much that ain't so".

The accumulating load of these events naturally impressed upon industrial management the need for a greater understanding of the private-enterprise system and of the part played in competitive capitalism by each unit of business. There followed, just as naturally, a realization that the annual report could be made to serve a broader purpose than had previously been the case. To achieve increased effectiveness it would, however, have to be made more attractive, not only to stockholders but also to employees and the public at large. It would first have to be opened and then read. The Caterpillar report for 1937 was, therefore, expanded from the previous 6 x 9 inch, 10 page, collection of words and figures, to an attractive 8 x 11 inch, 22 page, arrangement of data and comment with graphic and pictorial illustrations. For the first time the report was addressed to both stockholders and employees and was furnished to every employee of the company. It was also furnished to the members of what are deemed to be the thought-leadership groups in the plant communities.

With this broader approach to the use and function of the annual report there arose a need, not only to glamorize the report and popularize the comment, but also to present the financial information in such a way as to evidence the genuine desire to disclose more fully and to explain more clearly. In an effort to achieve this, the formal or conventional financial statements were supplemented by what were called "explanatory" statements of (1) assets and liabilities, and (2) income, expenses, profits and dividends, in which the conventional accounting titles for the various items were expanded in descriptive comment to indicate in more everyday language the nature or content of the item.

Caterpillar Tractor Co.

(a California Corporation)

STATEMENT 1

RESULTS OF OPERATIONS
AND SUMMARY OF PROFIT EMPLOYED IN THE BUSINESS

Calendar Year 1946

Sales			$128,437,494
Costs:			
Inventories brought forward from previous year		$ 32,086,876	
Add: Costs incurred during year:			
Materials, supplies, services purchased etc.	$78,309,077		
Wages, salaries, company contributions for group insurance, retirement plan, unemployment insurance and old-age benefits	52,183,569		
Portion of cost of buildings, machinery and equipment allocated to operations (depreciation)	1,388,035		
Interest (net)	(54,130)		
Federal income tax after deducting $808,681 computed under "carry-back" provisions of Internal Revenue Code	2,466,675		
		134,293,226	
		$166,380,102	
Deduct: Inventories carried forward to next year		44,054,199	
Costs allocated to year			122,325,903
Profit for year			$ 6,111,591
Add: Profit employed in the business at beginning of year			40,115,474
			$ 46,227,065
Deduct: Dividends of $3 per share paid in cash during year			5,646,720
Profit employed in the business at end of year			$ 40,580,345

* * *

Independent Auditors' Report

TO THE BOARD OF DIRECTORS OF CATERPILLAR TRACTOR CO:

We have examined the statement of financial position of Caterpillar Tractor Co. as of December 31, 1946, and the related statement of operations for the year then ended. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances, and included such tests of the accounting records and other supporting evidence and such other procedures as we considered necessary.

In our opinion, the accompanying financial statements 1 and 2 with the explanations in the management's report relating to physical inventories taken during the year and possible liabilities arising from

Caterpillar Tractor Co.

(a California Corporation)

STATEMENT 2

FINANCIAL POSITION

December 31, 1946

Current assets:			
Stated on basis of realizable values:			
Cash		$ 6,000,822	
United States Treasury Notes — Tax Series C		10,790,232	
Receivables, less estimated bad debts		16,036,096	
		$32,827,150	
Stated on basis of cost or market, whichever lower:			
Inventories		44,054,199	
			$76,881,349
Deduct: Current liabilities:			
Payables		$13,961,943	
Federal income tax	$4,365,468		
Deduct: United States Treasury Notes—Tax Series C	(4,365,468)		13,961,943
Net current assets (statement 5)			$62,919,406
Insurance, Taxes, etc.—cost allocable to future operations			128,206
Land, buildings, machinery and equipment—cost not allocated to operations (statement 6)			20,677,509
Patents, trade-marks and other intangibles — stated at nominal amount			1
			$83,725,122
Deduct: Ten-year 2% debentures due 1956			20,000,000
Net assets			$63,725,122
Derived From:			
Capital Stock common—stated capital (Statement 7)			$23,144,777
Profit employed in the business (Statement 7)			40,580,345
Capital Stock			$63,725,122

	Number of Shares Authorized	Issued
Preferred: five per cent cumulative — par value $100 per share	250,000	None
Common: without nominal or par value	2,500,000	1,882,240

* * *

suits for retroactive "portal to portal" pay, present fairly the position of the company at December 31, 1946, and the results of the operations for the year ended on that date, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

We have made annual examinations of the accounts of the company since incorporation and, in our opinion, the supplementary statements 3 to 7 fairly present the historical financial data for the years included therein.

Chicago, January 25, 1947 — Certified Public Accountants

At that time major consideration was given to the matter of terminology, but it was also recognized that there was need for an improvement in form. The explanatory balance-sheet at the end of 1937 was, therefore, presented in a single-column form in which liabilities were deducted from assets. The explanatory income statement for that year also presented a variation from conventional form in that all costs and expenses were deducted from all income to arrive at an amount which was described as: "a balance which was retained in the business and used for expansion of employment during the year."

The reports for the next six years carried further refinements of the ideas developed in 1937, and continued to receive wide acclaim. The approval came, however, largely from accountants and other businessmen. While we thought we had made a little progress we were not satisfied that we were reaching the mass audience which was our main objective. In the course of preparing for the 1944 report, we therefore again made a major reappraisal of the problem.

The Problem

Primarily, our job was to make the *results* of a somewhat technical process reasonably intelligible to an ordinary citizen who was neither blessed nor handicapped with any special training. But note that we were concerned with the *results* rather than the process. The art of accounting did not, therefore, have to be obscured by the technique of bookkeeping. To be sure, the beauties of any form of art can best be understood in the light of technical knowledge of the process by which it is produced; but a high degree of appreciation and attraction can, nevertheless, be experienced by those who lack the technical background but still have ears to hear and eyes to see.

These, then, were not to be statements of accountants, by accountants, for accountants. They were to be plain statements of informed opinion, uncompromising in their truthfulness—which, for this particular purpose, means that, within the limits of accepted accounting principles and of our very human abilities, they were to rest on judgments and estimates divorced of fancy and prejudice. And where such a presentation might possibly be misleading (as is always possible even with informed opinion and intellectual integrity), there would have to be clarifying

interpretation. Without sacrificing any of these great attributes for mere popularity, the statements also had to be stripped of distracting trivia, confusing prescription language and diverting complexity of form. There would be no purpose in giving the drivers of the economic train a power plant so complicated that absorption with the gadgets would leave no opportunity for a look at the tracks.

The statements were, furthermore, to bear the stamp of approval of highly reputable independent accountants whose examination and opinion would embrace the propriety of underlying detail which, although essential to the determination of important totals, need not be shown in the published financial statements. The purpose of such independent examination and opinion was, of course, to give assurance that, subject to the usual proper qualifications in the accountants' opinion, the statements were fairly presented. It was, therefore, to be presumed that the readers would accept the opinion as rendered. They, the readers, were to be audience, not auditors—a distinction sometimes missed by the critic.

At the same time we wished, if possible, to eliminate the somewhat embarrassing admission of deficiency implied by our use of both conventional and explanatory statements. Attention was, therefore, directed to the compilation of one set of financial statements which would be accounting-wise proper and yet readily convey to the lay reader a reasonably correct comprehension of just what the statements were meant to convey.

And what were the statements meant to convey? We thought we knew. Colloquially:

(1) How are we doing?—in terms of
  (a) What did we get in?
  (b) What did we do with it?
  (c) What's left
  (d) How is it left?
(2) Is that good or bad?

and these being relative terms we interpolate—

Is that better or worse?—

so that those who choose to do so might possibly guess at a conclusion to—

(3) Where do we go from here?

CATERPILLA

FINANCIAL POSITIO

	1946	1945	1944	1943	1942
Current assets:					
Cash	$ 6,000,822	$13,431,661	$ 5,796,268	$ 9,423,049	$ 4,622,7
Marketable securities	10,790,232	6,913,722	4,812,230	....	....
Receivables, less estimated bad debts	16,036,096	10,290,385	18,828,634	17,583,002	16,896,2
	$32,827,150	$30,635,768	$29,437,132	$27,006,051	$21,519,0
Inventories	44,054,199	32,086,876	40,703,519	35,476,892	37,263,7
	$76,881,349	$62,722,644	$70,140,651	$62,482,943	$58,782,8
Deduct: Current liabilities:					
Notes payable to banks due within one year	$........	$........	$ 5,000,000	$........	$ 3,500,0
Other payables	13,961,943	10,606,397	19,441,584	13,726,746	10,742,8
Federal income tax	4,365,468	12,599,748	18,349,390	21,080,613	14,950,1
Deduct: Treasury notes	(4,365,468)	(12,599,748)	(18,349,390)	(10,033,000)	(2,000,0
	$13,961,943	$10,606,397	$24,441,584	$24,774,359	$27,192,9
Net current assets (statement 5)	$62,919,406	$52,116,247	$45,699,067	$37,708,584	$31,589,8
Receivable in settlement of patent litigation less income tax thereon (settled in 1945)	....	....	3,600,000	3,600,000	3,600,0
Insurance, taxes, etc.	128,206	99,441	141,674	85,922	67,2
Miscellaneous properties	....	....	....	....	....
Land, buildings, machinery and equipment (statement 6)	20,677,509	11,044,562	12,013,214	16,494,615	20,330,5
Patents, trademarks and other intangibles	1	1	1	1	
	$83,725,122	$63,260,251	$61,453,956	$57,889,123	$55,587,6
Deduct:					
Ten-year 2% debentures due 1956	20,000,000	....	....	....	....
Notes payable to banks due after one year	....	....	....	....	1,500,0
Five-year convertible gold notes	....	....	....	....	....
Net assets	$63,725,122	$63,260,251	$61,453,956	$57,889,123	$54,087,6
Derived from:					
Preferred stock	$........	$........	$........	$........	$.......
Common stock (statement 7)	23,144,777	23,144,777	23,144,777	23,144,777	23,144,7
Profit employed in the business (statement 7)	40,580,345	40,115,474	38,309,179	34,744,346	30,942,8
	$63,725,122	$63,260,251	$61,453,956	$57,889,123	$54,087,6

RESULTS OF OPERATIO

	1946	1945	1944	1943	1942
Sales	$128,437,494	$230,599,818	$242,164,753	$171,356,659	$142,168,8
Costs:					
Inventories brought forward from previous year	$ 32,086,876	$ 40,703,519	$ 35,476,892	$ 37,263,776	$ 30,580,1
Add: Costs incurred during year:					
Materials, supplies, services purchased, etc.	78,309,077	139,646,740	146,659,221	87,550,952	78,004,1
Wages, salaries, company contributions for group insurance, retirement plan, unemployment insurance and old-age benefits	52,183,569	62,151,665	70,356,524	51,360,761	43,913,5
Portion of cost of buildings, machinery and equipment allocated to operations (depreciation)	1,388,035	4,575,801	5,414,136	4,941,946	4,453,1
Interest (net)	(54,130)	(174,936)	16,047	(2,578)	106,7
Federal income tax	2,466,675	9,272,010	17,616,139	18,152,748	15,277,4
	$166,380,102	$256,174,799	$275,538,959	$199,267,605	$172,425,1
Deduct: Inventories carried forward to next year	44,054,199	32,086,876	40,703,519	35,476,892	37,263,7
Costs allocated to year	$122,325,903	$224,037,923	$234,835,440	$163,790,713	$135,162,1
	$ 6,111,591	$ 6,511,895	$ 7,329,313	$ 7,565,946	$ 7,006,0
Income from settlement of patent litigation, less income tax thereon	....	....	....	....	....
Profit for year	$ 6,111,591	$ 6,511,895	$ 7,329,313	$ 7,565,946	$ 7,006,0
Profit percentage of sales	4.76%	2.82%	3.03%	4.42%	4.9

TRACTOR CO.

at December 31 Each Year

STATEMENT 3

1941	1940	1939	1938	1937	1936	1935	1934	1933	1932
$ 5,380,621	$ 6,693,770	$ 3,642,358	$ 5,296,917	$ 2,271,876	$ 2,309,929	$ 3,422,181	$ 3,241,410	$ 4,629,243	$ 2,773,026
....	....	....	....	....	....	....	158,035	1,708,470	4,974,971
8,457,259	8,320,588	7,737,182	8,938,268	10,161,539	11,576,036	9,918,242	7,682,393	8,827,195	8,502,197
$13,837,880	$15,014,358	$11,379,540	$14,235,185	$12,433,415	$13,885,965	$13,340,423	$11,081,838	$15,164,908	$16,250,194
30,580,144	21,034,395	19,383,113	18,316,659	22,769,013	16,670,371	12,178,762	10,549,080	8,804,223	7,837,632
$44,418,024	$36,048,753	$30,762,653	$32,551,844	$35,202,428	$30,556,336	$25,519,185	$21,630,918	$23,969,131	$24,087,826
$.........	$.........	$ 500,000	$.........	$ 1,000,000	$ 500,000	$.........	$.........	$.........	$.........
7,507,843	5,721,627	4,289,117	2,753,272	2,517,178	3,194,707	2,100,319	1,123,676	1,148,600	806,814
8,706,749	3,859,306	1,408,643	937,290	1,806,894	1,755,305	1,175,000	586,220	45,124	20,175
....	....	....	....	....	....	....	....	....	....
$16,214,592	$ 9,580,933	$ 6,197,760	$ 3,690,562	$ 5,324,072	$ 5,450,012	$ 3,275,319	$ 1,709,896	$ 1,193,724	$ 826,989
$28,203,432	$26,467,820	$24,564,893	$28,861,282	$29,878,356	$25,106,324	$22,243,866	$19,921,022	$22,775,407	$23,260,837
3,600,000	3,600,000	3,600,000	3,600,000	3,600,000	3,204,000	2,824,000	2,524,000	2,376,000	2,325,000
23,090	29,289	35,956	44,800	56,414	35,121	35,315	19,126	110,875	239,070
....	....	....	....	....	201,970	229,158	322,170	347,760	451,854
22,018,954	20,766,020	19,099,577	20,141,991	20,363,337	18,845,241	16,168,260	16,229,463	17,049,380	17,963,268
1	1	1	1	1	1	1	1	1	1
$53,845,477	$50,863,130	$47,300,427	$52,648,074	$53,898,108	$47,392,657	$41,500,609	$39,015,782	$42,659,441	$44,260,030
....	....	....	....	....	....	....	....	....	....
3,000,000	4,000,000	4,500,000	....	....	....	....	....	....	....
....	....	....	....	....	....	....	....	5,090,000	6,809,000
$50,845,477	$46,863,130	$42,800,427	$52,648,074	$53,898,108	$47,392,657	$41,500,609	$39,015,782	$37,569,441	$37,451,030
$.........	$.........	$.........	$11,515,200	$11,661,496	$ 6,014,776	$.........	$.........	$.........	$.........
23,144,777	23,144,777	23,144,777	23,144,777	23,144,777	23,144,777	23,144,777	23,144,777	23,144,777	23,144,777
27,700,700	23,718,353	19,655,650	17,988,097	19,091,835	18,233,104	18,355,832	15,871,005	14,424,664	14,306,253
$50,845,477	$46,863,130	$42,800,427	$52,648,074	$53,898,108	$47,392,657	$41,500,609	$39,015,782	$37,569,441	$37,451,030

for the Calendar Years

STATEMENT 4

1941	1940	1939	1938	1937	1936	1935	1934	1933	1932
$101,957,987	$73,062,514	$58,432,921	$48,246,140	$63,183,487	$54,118,004	$36,447,193	$23,769,321	$14,408,002	$13,258,505
$ 21,034,395	$19,383,113	$18,316,659	$22,769,013	$16,670,371	$12,178,762	$10,549,080	$ 8,804,223	$ 7,837,632	$ 9,506,692
57,782,137	37,104,924	30,208,309	20,852,307	33,965,424	28,177,755	18,459,530	11,956,060	8,203,298	6,457,084
34,006,824	23,454,841	19,653,605	16,716,329	21,655,362	17,435,726	11,234,478	7,983,726	5,230,239	5,292,417
3,677,388	2,563,876	2,541,086	2,408,165	2,186,061	1,891,059	1,790,273	1,805,675	1,792,979	1,731,219
(77,316)	(71,206)	(232,640)	(344,671)	(499,223)	(509,978)	(459,027)	(430,028)	(179,588)	(157,827)
8,367,876	3,834,178	1,324,125	925,946	1,805,815	1,765,459	1,072,314	547,555	24,948	....
$124,791,304	$86,269,726	$71,811,144	$63,327,089	$75,783,810	$60,938,783	$42,676,648	$30,667,211	$22,909,508	$22,829,585
30,580,144	21,034,395	19,383,113	18,316,659	22,769,013	16,670,371	12,178,762	10,549,080	8,804,223	7,837,632
$ 94,211,160	$65,235,331	$52,428,031	$45,010,430	$53,014,797	$44,268,412	$30,497,886	$20,118,131	$14,105,285	$14,991,953
$ 7,746,827	$ 7,827,183	$ 6,004,890	$ 3,235,710	$10,168,690	$ 9,849,592	$ 5,949,307	$ 3,651,190	$ 302,717	$(1,733,448)
....	....	....	....	396,000	380,000	300,000	148,000	51,000	112,000
$ 7,746,827	$ 7,827,183	$ 6,004,890	$ 3,235,710	$10,564,690	$10,229,592	$ 6,249,307	$ 3,799,190	$ 353,717	$(1,621,448)
7.60%	10.71%	10.28%	6.71%	16.72%	18.90%	17.15%	15.98%	2.46%	(12.23%)

SOURCE AND DISPOSITION OF NET CURRENT ASSETS

	Total from Incorporation	1946	1945	1944	1943	1942
Source of net current assets:						
Operations which increased net current assets by the following amounts:						
Profit for period excluding income from settlement of patent litigation	$130,422,752	$ 6,111,591	$ 6,511,895	$ 7,329,313	$ 7,565,946	$ 7,006,660
Portion of cost of buildings, machinery and equipment allocated to operations during period (depreciation)	50,091,750	1,388,035	4,575,801	5,414,136	4,941,946	4,453,947
Income from settlement of patent litigation, less income tax thereon	3,600,000	....	3,600,000	....	....	....
Capital assets sold or scrapped, etc.	3,222,701	34,386	102,115	267,528	107,253	429,984
Common stock issued	9,632,183	....	....	....	....	....
Ten-year 2% debentures issued	20,000,000	20,000,000	....	....	....	....
Long-term notes issued	5,000,000	....	....	....	....	....
Five-year convertible gold notes issued	10,000,000	....	....	....	....	....
	$231,969,386	$27,534,012	$14,789,811	$13,010,977	$12,615,145	$11,890,591
Disposition of net current assets:						
Dividends paid:						
In cash	$ 81,780,911	$ 5,646,720	$ 4,705,600	$ 3,764,480	$ 3,764,480	$ 3,764,480
In preferred stock issued in 1936 and 1937 retired in 1938 and 1939	11,661,496	....	....	....	....	....
Land, buildings, machinery and equipment purchased	68,157,926	11,084,133	3,667,031	1,256,014	1,231,942	3,239,682
Long-term notes paid	5,000,000	....	....	....	1,500,000	1,500,000
Five-year convertible gold notes paid	10,000,000	....	....	....	....	....
	$176,600,333	$16,730,853	$ 8,372,631	$ 5,020,494	$ 6,496,422	$ 8,504,162
Increase or (decrease) in net current assets during period	$ 55,369,053	$10,803,159	$ 6,417,180	$ 7,990,483	$ 6,118,723	$ 3,386,429
Net current assets at beginning of period	7,550,353	52,116,247	45,699,067	37,708,584	31,589,861	28,203,432
Net current assets at end of period (statement 3)	$ 62,919,406	$62,919,406	$52,116,247	$45,699,067	$37,708,584	$31,589,861

LAND, BUILDINGS, MACHINERY AND EQUIPMENT

	1946	1945	1944	1943	1942
Cost:					
Land	$ 1,690,970	$ 1,434,131	$ 1,498,593	$ 1,719,549	$ 1,719,549
Buildings	10,346,889	7,823,725	9,678,389	10,722,708	10,707,288
Machinery and equipment	21,173,116	16,469,671	25,511,202	26,322,188	26,853,504
	$33,210,975	$25,727,527	$36,688,184	$38,764,445	$39,280,341
Deduct: Portion of above cost allocated to operations to date shown:					
Land	$.........	$.........	$ 88,452	$ 62,381	$ 36,310
Buildings	5,081,433	4,841,764	6,458,291	6,715,524	5,927,815
Machinery and equipment	7,452,033	9,841,201	18,128,227	15,491,925	12,994,678
	$12,533,466	$14,682,965	$24,674,970	$22,269,830	$18,958,803
Cost not allocated to operations to date shown (statement 3):					
Land	$ 1,690,970	$ 1,434,131	$ 1,410,141	$ 1,657,168	$ 1,683,239
Buildings	5,265,456	2,981,961	3,220,098	4,007,184	4,779,473
Machinery and equipment	13,721,083	6,628,470	7,382,975	10,830,263	13,867,826
	$20,677,509	$11,044,562	$12,013,214	$16,494,615	$20,330,538

NOTE: Whenever the cost of any unit of land, buildings, machinery and equipment has been fully allocated to operations, such cost is eliminated from the accounts.

TRACTOR CO.

from Incorporation in 1925 to December 31, 1946

STATEMENT 5

1941	1940	1939	1938	1937	1936	1935	1934	1933	Total from Incorporation through 1932
$ 7,746,827	$ 7,827,183	$ 6,004,890	$ 3,235,710	$10,168,690	$ 9,849,592	$ 5,949,307	$ 3,651,190	$ 302,717	$41,161,241
3,677,388	2,563,876	2,541,086	2,408,165	2,186,061	1,891,059	1,790,273	1,805,675	1,792,979	8,661,323
....	....	....	....	....	....	....	....	....	....
66,026	128,627	671,052	221,794	294,506	117,837	360,703	144,868	280,583	(4,561)
....	....	....	....	....	....	....	....	....	9,632,183
....	....	....	....	....	....	....	....	....	....
....	....	5,000,000	....	....	....	....	....	....	....
....	....	....	....	....	....	....	....	....	10,000,000
$11,490,241	$10,519,686	$14,217,028	$ 5,865,669	$12,649,257	$11,858,488	$ 8,100,283	$ 5,601,733	$ 2,376,279	$69,450,186
$ 3,764,480	$ 3,764,480	$ 4,337,337	$ 4,339,448	$ 4,059,239	$ 4,337,544	$ 3,764,480	$ 2,352,849	$ 235,306	$29,179,988
....	....	11,515,200	146,296	....	....	....	....	....	....
4,990,149	4,352,279	2,160,880	2,396,999	3,817,986	4,658,486	2,012,959	1,013,269	907,403	21,368,714
1,000,000	500,000	500,000	....	....	....	....	....	....	....
....	....	....	....	....	....	....	5,090,000	1,719,000	3,191,000
$ 9,754,629	$ 8,616,759	$18,513,417	$ 6,882,743	$ 7,877,225	$ 8,996,030	$ 5,777,439	$ 8,456,118	$ 2,861,709	$53,739,702
$ 1,735,612	$ 1,902,927	$(4,296,389)	$(1,017,074)	$ 4,772,032	$ 2,862,458	$ 2,322,844	$(2,854,385)	$ (485,430)	$15,710,484
26,467,820	24,564,893	28,861,282	29,878,356	25,106,324	22,243,866	19,921,022	22,775,407	23,260,837	7,550,353*
$28,203,432	$26,467,820	$24,564,893	$28,861,282	$29,878,356	$25,106,324	$22,243,866	$19,921,022	$22,775,407	$23,260,837

*Net current assets acquired at incorporation

at December 31 Each Year

STATEMENT 6

1941	1940	1939	1938	1937	1936	1935	1934	1933	1932
$ 1,691,470	$ 1,666,591	$ 1,588,837	$ 1,582,836	$ 1,691,570	$ 1,691,570	$ 1,687,277	$ 1,701,502	$ 1,701,502	$ 1,691,502
9,954,468	9,655,909	9,023,030	9,089,608	8,888,465	8,353,320	8,077,805	8,217,949	8,184,217	8,190,220
27,648,679	24,821,596	22,557,797	22,640,046	22,344,611	20,415,505	17,124,044	16,166,731	16,025,139	15,890,263
$39,294,617	$36,144,096	$33,169,664	$33,312,490	$32,924,646	$30,460,395	$26,8[illegible],126	$26,086,182	$25,910,858	$25,771,985
$ 14,304	$.........	$.........	$.........	$.........	$.........	$.........	$.........	$.........	$.........
5,502,167	5,136,471	4,806,469	4,348,071	3,935,992	3,554,537	3,315,511	3,069,058	2,667,110	2,268,346
11,759,192	10,241,605	9,263,618	8,822,428	8,625,317	8,060,617	7,405,346	6,787,661	6,194,359	5,520,371
$17,275,663	$15,378,076	$14,070,087	$13,170,499	$12,561,309	$11,615,154	$10,720,857	$ 9,856,719	$ 8,861,469	$ 7,788,717
$ 1,677,166	$ 1,666,591	$ 1,588,837	$ 1,582,836	$ 1,691,570	$ 1,691,570	$ 1,687,277	$ 1,701,502	$ 1,701,502	$ 1,691,502
4,452,301	4,519,438	4,216,561	4,741,537	4,952,473	4,798,783	4,762,294	5,148,891	5,517,107	5,921,874
15,889,487	14,579,991	13,294,179	13,817,618	13,719,294	12,354,888	9,718,698	9,379,070	9,830,780	10,369,892
$22,018,954	$20,766,020	$19,099,577	$20,141,991	$20,363,337	$18,845,241	$16,168,269	$16,229,463	$17,049,389	$17,983,268

We had, therefore, to give not only the facts of economic life for the period covered by the report but had to give them in such a way as would help the adolescent reader view them with a sense of proportion and perspective.

In approaching the problem it was natural that we should attempt to appraise, first, those matters which seemed to give the general reader the most difficulty and create the greatest misunderstanding. In this connection I use the word "seemed" because we have found it very difficult to obtain from those without some accounting training a reasonably clear understanding of just where the troubles lie. This, of course, is to be expected—and in other fields of endeavor the matter could be dismissed on a take-it-or-leave-it basis. We, however, were sending a message to the people and we felt it was more our obligation to get the message through to the people than their obligation to learn how to tune in on our special wavelength.

We had, nevertheless, gathered some fairly definite impressions; that one of the troubles with the balance-sheet was that it balanced, that something called "surplus" was plugged in to make it balance, that "capital" was grouped with the liabilities rather than with the assets, that reserves did not seem to be reserves in the usual sense of the word.

The Statement of Financial Position

With these points for a start we tried to place ourselves in the position of the untrained reader looking in rather than the trained accountant looking out. The fundamental difference seemed to be that while the latter knew his debits from his credits, the former was blissfully ignorant of such subtle distinctions. Double-entry—which, as a mode of thinking, is perhaps the trained accountant's greatest asset—had created an equation which could only puzzle the layman left to wonder why the sum of the things on the left was always the same as the sum of the things on the right. His own affairs, he hoped, would never get into such a sorry state of unprogressive equilibrium. But trial-balance thinking did not have to be extended from the general ledger to the published financial statements and the general public did not have to be subjected to the seductive technicalities of the system. So we attempted to destroy some of the undue influence which double-entry bookkeeping has had upon the presentation of results derived therefrom (and upon

financial accounting as a whole) by adopting a single-column form in which liabilities were deducted from assets to arrive at the total owner capital invested in the business. This form (as modified slightly over the ensuing years) is shown at Statement 2 in the accompanying reproduction of the company's financial statements for the year 1946.

By this change of form we killed two or three birds and cut a couple of Gordian knots. Surplus and capital were still there, but they no longer arose like a black-market thumb to balance the scales.

First of the questions prompted by this arrangement was whether all of the liabilities should be deducted from all of the assets or whether there should be an intermediate step not only to recognize the conventional segregation of so-called current assets and current liabilities, but also to place these two groupings in juxtaposition. In favor of the "total" treatment was its greater simplicity. This method would also have been more consistent with the "going-concern" basis upon which the statements are presented since it would not have involved a somewhat artificial distinction between deferred charges for inventories and for plant and equipment—neither of which can have any going-concern utility without the other. Use of the "total" treatment would, furthermore, have permitted ready avoidance of labels such as "current", "net current" or "working"—with their counter-implications that items not so described were perhaps lower on the scale of social worthiness.

Nevertheless, we adopted the alternative treatment whereby the conventional current items were grouped and a balance struck to arrive at what we first called "working capital" but now prefer to describe as "net current assets" (because the earlier term was more a definition than a logical derivative of the process). The complication, we felt, was not too great for most of those who might attempt to understand the statement and such treatment would, presumably, be helpful to accountants, bankers, investment analysts and others who were in the habit of thinking in terms of "current" relationships. Loan agreements and other credit instruments commonly called for the maintenance of net current assets as determined in accordance with accepted accounting principles which had not (yet) rejected the "current" classifications. This method, furthermore, lent itself to a comparative summary (Statement 3) in

which the changing relationships were brought out more clearly than would otherwise be the case.

In this part of Statement 2 it will also be observed that we have adopted a somewhat unusual presentation to bring out the differing bases upon which the assets have been accounted for. While the statement of financial position reflects totals which are, of themselves, useful, it should nevertheless be thoroughly understood that these totals are composed of elements which are not homogeneous. Recognition of this accounting fact is, in our opinion, fundamental to any proper interpretation of the statement, and it is particularly important that lay readers realize the limited extent to which current realization values find a place among the conventional and historical bases for asset accounting. We have, accordingly, shown the cash items and receivables to be stated on the basis of "realizable values," thereby defining that particular realm of thought and at least creating the presumption that the things outside such limits are stated on some other basis.

Before leaving the current position, it might be well to comment on the matter of inventories, in which we were taken to task some time ago in one of the accounting periodicals. We had not disclosed the all-revealing secrets of the segregation of raw materials, work-in-process, and finished goods. In our inventories we have scrap metal and pig iron with which to make our own grey-iron castings; we have also purchased castings and forgings which are machined through two to twenty operations to produce pieces parts; we have purchased steel in bars, channels, strips, shapes, sheets which are cut, stamped, welded into other forms; we have purchased finished parts which may be either incorporated in assemblies or sold individually as replacement parts. Where does "raw" become "in-process" or "finished"? We do not know—and unless the reader is cognizant of whatever classification we might happen to choose to adopt how could any portent of the segregation be appraised? Furthermore, for purposes of operating management we do not think we need the segregation badly enough to warrant the cost of evaluating the many thousands of requisitions effecting transfers between the usual inventory subdivisions. (Instead, we have what we find to be much more useful—a segregation of material, labor and manufacturing overhead in inventory.) Insist-

ence upon the underlying details of inventories is, therefore, in our opinion, an unwarranted assumption by the outside critic that he knows how to interpret from them.

Continuing with Statement 2, our treatment (or mistreatment) of the "reserve for depreciation" is perhaps of passing interest. We wished, first, to avoid use of both the words "reserve" and "depreciation," each of which has in accounting statements a specialized meaning not likely to be apparent to the uninitiated. In ordinary language a reserve is something stored or held back for future use (like nuts in a squirrel's nest)—and to leave anyone with the impression that a reserve for depreciation conforms to that definition is to mislead. "Depreciation" also is a misnomer. In the colloquial sense it relates to a lessening of value without regard to the cause of the loss. Our method of computing depreciation—being that most generally used throughout industry—made no attempt to measure changes in value or degrees of physical exhaustion within an accounting period. We merely distributed in a systematic manner the cost of the applicable facilities over the number of accounting periods for which the facilities might reasonably be expected to have an effective service life. The process was clearly one of allocation and not of valuation.

So, throughout the statements we continue that thought description by terming the annual charge; "portion of cost (of facilities) allocated to operations" for the year (Statement 1), and the reserve: "portion of cost allocated to operations to date" (Statement 6). And since this latter exhibit is furnished for the specific purpose of giving helpful details, we deem it better to show in the statement of financial position only the net balance of "cost not allocated to operations." (The inclusion of land in the asset classification prohibits the otherwise more desirable: "cost allocable to future operations.") By following the reference to the supporting analysis there are then available the major classification details necessary to a reasonable understanding on this phase of the subject—an understanding which cannot be obtained from gross totals only.

In a fine shading of semantics we believe that, by the use of "cost allocated," we have lost none of that idea of an orderly, rational method which accountants have thought (or hoped) was conveyed by the word "depreciation."

Caterpillar Tractor Co.

SOURCES OF NET ASSETS — STATEMENT 7

Capital Stock, Common

Year		*Number of Shares*	*Amount*
1925	Issued at incorporation for net assets of predecessor companies ....(1)	1,625,000	$12,320,380
1928	Issued for net assets of Russell Grader Manufacturing Company	86,127	2,518,416
1929	Issued for cash at $50 per share (less underwriting fees)	171,113	8,305,981
		1,882,240	$23,144,777

Profit Employed in the Business

Year	Profit Amount	Profit Per share of common stock	Dividends Amount	Dividends Per share of common stock	Amount for Year	Amount at end of Year
1925	$ 3,263,669	$12.55	$ 649,874	$2.50	$2,613,795	$ 2,613,795
1926	4,318,095	2.66	1,624,976	5.25	2,693,119	5,306,914
1927	5,731,423	3.53	2,681,249	1.65	3,050,174	8,357,088
1928	8,717,838	5.09	4,225,000	2.60	4,492,838	12,849,926
1929	12,413,446	6.60	5,646,720	3.00	6,766,726	19,616,652
1930	9,094,018	4.83	7,528,960	4.00	1,565,058	21,181,710
1931	1,569,200	.83	5,646,720	3.00	(4,077,520)	17,104,190
1932	(1,621,448)	(.86)	1,176,489	.62½	(2,797,937)	14,306,253
1933	353,717	.19	235,306	.12½	118,411	14,424,664
1934	3,799,190	2.02	2,352,849	1.25	1,446,341	15,871,005
1935	6,249,307	3.32	3,764,480	2.00	2,484,827	18,355,832
1936	10,229,592	5.43	(2) 10,352,320	5.50	(122,728)	18,233,104
1937	10,564,690	(4) 5.46	(2)(3) 9,705,959	5.00	858,731	19,091,835
1938	3,235,710	(4) 1.41	(3) 4,339,448	2.00	(1,103,738)	17,988,097
1939	6,004,890	(4) 2.89	(3) 4,337,337	2.00	1,667,553	19,655,650
1940	7,827,183	4.16	3,764,480	2.00	4,062,703	23,718,353
1941	7,746,827	4.12	3,764,480	2.00	3,982,347	27,700,700
1942	7,006,660	3.72	3,764,480	2.00	3,242,180	30,942,880
1943	7,565,946	4.02	3,764,480	2.00	3,801,466	34,744,346
1944	7,329,313	3.89	3,764,480	2.00	3,564,833	38,309,179
1945	6,511,895	3.46	4,705,600	2.50	1,806,295	40,115,474
1946	6,111,591	3.25	5,646,720	3.00	464,871	40,580,345

Notes:

(1) At incorporation, 260,000 shares were issued. In February, 1926, the issued shares were increased by a 25% stock dividend to 325,000. In December 1926, a conversion of five shares for one share increased the issued shares to 1,625,000.

(2) Including dividends paid in preferred stock of $6,014,776 in 1936 and $5,646,720 in 1937. Preferred stock was retired in 1938 and 1939.

(3) Including preferred-stock dividends of $294,759 in 1937, $574,968 in 1938 and $572,857 in 1939.

(4) After deducting preferred-stock dividends.

This brings us down to the sum of net current assets plus other assets—before deducting long-term liabilities—and we confess failure to reach any happy expression which would seem to describe this balance more aptly than no description at all. With a call for help we will, therefore, pass on to the net difference between all assets and all liabilities—and how to label it. To describe it as capital stock plus surplus would defeat our entire purpose, and would smack of alchemy. Net worth, a value concept, was, of course, unacceptable. So, having revised our thinking to favor "net current assets" for the description of that balance, we concluded that the final balance could be best described as "net assets"—a term which would seem to be reasonably understandable to most people who have both possessions and creditors.

And whence did these good things come? From contributions received from stockholders and from profit not disbursed as dividends. So, in selecting a phrase to lead the reader from the net assets to their source of origin, we resisted temptations towards "evidenced by" or "represented by" in favor of "derived from" capital stock and profit retained in the business since incorporation.

In doing so we realize that we are adopting terminology which cannot be universally applicable—as, for example, when profits have been incorporated into legal capital by stock dividend or other appropriate action. We are not, therefore, wholly happy with our solution. It *is*, however, applicable in our particular case and we have seen no other wording of more universal acceptance which will better convey the idea of derivation from the contributory sources.

In this connection it is my present thinking that progress toward a more universally suitable liaison phrase might be found in the direction of some such wording as "being an accounting for"—thereby bringing out more strongly the underlying concept of a stewardship in which the net assets constitute an accounting for ownership capital.

At this point it may be of interest to note that our 1944 restudy led us to a stronger recognition of the fact that, in our position, a paid-in capital surplus was not wholly compatible with a common stock "without nominal or par value." By appropriate action early in 1945, paid-in sur-

plus was, accordingly, transferred to common-stock account —with hygienic benefits upon the whole presentation.

For our purpose, the term "surplus"—even if "earned" —was, of course, thoroughly objectionable. As far as possible we intended to use words in their popular everyday meaning, and, despite its special accounting connotation to the initiated few, "surplus" inevitably conveyed to the general reader the idea of too much, more than enough, a lot of corn in a lot of bins, left-over war matériel. In search for a substitution, thoughts naturally turned to such alternatives as "undistributed profits" and "profit invested in the business." "Undistributed," however, seemed to convey an idea that maybe the profits would be distributed—when, of course, they could not be; and "invested" seemed to create a possible question related to the purchase or other acquisition of capital stock—a common implication of the term. "Reinvested" we rejected since it seemed merely to compound the trouble with "invested" by raising a time element. "Kept" had perhaps only the disadvantage that it was too crudely simple; "left" had a strong appeal; and "held" seemed to be more acceptable when it was spelled "retained". So we used "retained"—until we encountered sufficient objections from our "relations" people who thought that the term failed to connote the "putting to use" inferred by "invested". So we changed to "employed".

In a further effort to improve the presentation we then made what we believe to be a simplifying segregation of legal matter from more strictly financial accounting. We reported the details of the capital stocks as to shares authorized and issued as an item of information related to, but not an integral part of, the main financial presentation.

And having done these things to the old balance-sheet, we decided we should no longer call it a balance-sheet. We recognized, of course, that the term had become somewhat institutionalized to connote a financial summary of assets and liabilities even without the balancing feature; and we realized also that while we had eliminated one equation we had set up another in showing that "net assets" constituted an accounting for, and was, therefore, *equal to* capital stock plus profit employed in the business. Nevertheless, we felt that we had departed sufficiently from the conventional form to warrant departure from the conventional

title—and that, in any case, the term "balance-sheet" could be improved upon.

We first ruled out "condition" in a possible title for the statement—on the grounds that it conveyed ideas of realizable value, and, possibly, liquidation. This left us with "position" as the best alternative we could think of—and recalled to mind that several years ago the public accounting profession had standardized on that description in its opinions on corporate statements. At the same time the profession had discontinued use of the qualifying adjective "financial"—on the ground, I believe, that it was thought to be a factor contributing to the fallacy that the balance-sheet presented realizable values. Nevertheless, we felt that the title would not be as helpfully descriptive if the adjective were omitted and we, therefore, adopted "financial position".

In this connection, we have recently received an interesting suggestion favoring "accounting position". Some consideration might also be given to the idea of "statement of stewardship" or "stewardship position."

The Statement of Operations

Turning next to the statement of operations, we decided that our former practice of deducting the separate elements of cost and expense to arrive at various subtotals was not only arithmetically confusing but tended to convey an erroneous impression as to their incidence and importance. In all our thinking we proceeded from the premise that the presentation was to reflect a "going-concern" basis; and this being the case, there could be no question regarding the relative necessity of the expenditures since they were all to be deemed equally necessary for the operation of the business and all deductible from income before arriving at any figure which could be considered to be profit. We, therefore, deducted a total of all costs and expenses from sales income to arrive at profit for the year as shown in the statement of operations for the year 1946—Statement 1 in the set of financial statements accompanying this article.

In approaching this phase of the problem we attempted to make such a presentation as we thought would be of most helpful interest to most of the readers and we felt that this could best be achieved if we were to follow natural,

homogeneous classifications applicable as far as possible to both the peanut vendor and the billion-dollar corporation. Thus we show one total of all materials, supplies, and services purchased and another total for all employee compensation. The general reader is thereby given information which seems more likely to be of interest than would nondisclosure of these totals in an alternative grouping whereby so-called manufacturing costs would be segregated from commercial overhead (especially when the basis of segregation would be unknown). Such a latter grouping is probably more generally used for internal-management purposes and, for such purposes, may well have greater value. This would be especially true where there are separate groupings of all the costs which are passed through inventories and of all the costs or expenses which are excluded from inventories. But for internal-management purposes there are available all sorts of classifications which would be either too confusing for general consumption or too revealing for competitive consumption.

This point is worth pausing on—for there are always some outside analysts who feel somewhat thwarted when they do not have as voluminous detail as they think would enable them to walk on common ground with the internal management (or even to manage the business by remote control). It should, therefore, be understood that published financial statements designed for general public consumption cannot reasonably be of the same nature as the many varying and detailed analyses available to the internal interpreters for more specific management purposes. And we do not believe that the general reader expects or wishes to be given a mass of necessarily complex information which might delight the expert analyst (who generally seems to know too much ever to be a stockholder) but would certainly confuse and confound the reader whom we are trying most to reach. We, accordingly, selected from the alternatives what we thought would interest rather than repel most of our readers, who would include stockholders, employees, and the local community.

Comment has already been made on the depreciation charge.

Our inclusion of federal income taxes in the total to be deducted direct from sales income has met with expected

opposition—and unexpected support. There is, of course, a statutory concept of taxable income, but we felt we could no longer subscribe to such a contradiction as "profit before income taxes." Neither did we wish to foster any ideas that lower tax rates would necessarily mean higher profits. Tax rates, we believe, have an influence upon every aspect of "doing business"—on costs, prices, volume and profits; and profits, or the prospects therefor, have a bearing on taxes. In such an interplay of forces there can be no reliable conclusions as to what would be if things which are were not.

Nor do we wish in any way to appear to subscribe to the dangerous fallacy that business is merely a middleman in the tax gathering process—a pipeline from the customer's pocket to the government treasury. Such an idea rests on a cost-plus method of reasoning which assumes that price is the product of an arithmetical process rather than the result of economic forces which frequently defy the adding machine. The corporation does not have the power to pay taxes or wages or any other costs without limit. And the United States federal income tax—levied on the corporation as such—is neither a sales tax upon the customers nor a personal tax upon the stockholders.

Furthermore, while it is an obligation of business to pay taxes, it is not an objective for which business is created. The prime purpose of business still remains the earning of an adequate return on its capital investment—and successful business is that business which succeeds in adjusting itself to the changing impacts of changing forces so that it may survive to serve its designated purpose. The essential point for our present purpose is, however, that it is only the residue left stockholders which makes our present form of competitive capital enterprise possible.

We are also stubbornly old-fashioned in clinging to a belief that the Federal Government is still meant to be the servant of the corporation—not the master. It contributes no capital, shares no losses, has no equity in the net assets, and is not an equity holder. We could not, therefore, consider the payment for federal protection (which, in a broad sense, should be the sole purpose of government) to be an allocation or distribution of profits among owners. It is a payment for services rendered—often very badly and always at a very high cost—but presumed to be services

which, over the long term, enhance or at least preserve business opportunities. For purposes of our presentation we, therefore, felt we could better bring out the verities of the situation by discarding the more traditional treatment and adopting the "one-step" deduction method.

Before leaving this point, it might also be well to face the objection sometimes raised against our type of treatment that federal income taxes are not suitable for use in the determination of costs or prices of individual products. We, however, feel there is no necessary relationship between the treatment of taxes in the income statement and their lack of utility for such purposes. In our detailed analyses of operating results by product classifications we do make an allocation of income taxes to the various groupings and this serves our general purpose satisfactorily.

In our treatment of inventories in the operating statement we have decided to revert to showing the opening and closing balances. Heretofore, we reported only the change in the inventories from beginning to end of the year and did so in the belief that we were bringing into sharper focus a factor which we consider to be of greater significance than is generally accorded. Thus, whether the dollar amount of change be large or small we believe it an important part of financial-statement interpretation to consider the effect on operations of production in excess of sales or sales in excess of production. This is particularly true when a substantial volume of costs does not pass through inventories and where the results from manufacturing and the results from selling are, accordingly, of separate significance. Proper appraisal of the inventory position at the end of the period would also seem to require understanding of the changes in inventory in relation to sales trends.

Nevertheless, the fact remained that the procedure of adding to costs the decreases in inventories or deducting from costs the increases in inventories was a point of major confusion among all but the expert—and we decided that the expert could figure out the change with his own pencil rather than ours.

The purpose of applying the change in inventories to the costs is, of course, to adjust costs *incurred* during the year to cost *allocated* to the year. Failure to appreciate this appeared to be the main reason for the trouble with our earlier treatment. It seemed, therefore, desirable that

we attempt better to bring out the underlying reason for either treatment and this we are now doing by adopting subtitles distinguishing between "costs incurred" and "costs allocated"—as shown in Statement 1.

An interesting exception has been taken to our use of the term "profit" on the grounds that it conveys a sense of finality—of marking a terminal point in operations, which, of course, is not the case. We, however, had no such connotation in our minds since we knew, and thought most others realized, that profit is a transitory, illusory will-of-the-wisp—here today and gone tomorrow (with the tax collector getting in somewhere between.) The thought has also been expressed that "profit" has acquired a stigma—as something left over—without apparent social justification—and that this could now be overcome only by use of alternative terminology such as "earnings" or "income". We had almost the opposite approach—that profit and the system which makes it possible are things with honor and that their honor can best be defended by meeting the challenge offered by financial statements.

And having done these things to the statement of profit and loss, we decided that once again the technical jargon of accounting had created some difficulty. The statement might be one of profit or one of loss; but it could hardly be one of both. The essential point was its purport to report on the operations of the business for the fiscal period. It seemed, therefore, simplest and clearest just to title it "results of operations"—and so we did.

We then made one further rearrangement to recognize the fact that most readers look first at the statement of operations and then proceed to the statement of financial position. We placed the former before the latter.

Conclusion

In reaching all our conclusions it was our purpose and intent to preserve the financial statements as an integral part of a report of stewardship. But we approached the problem with a broadened concept of what is meant by stewardship. In the course of events, our responsibility, like our company, had expanded; and over the years there had been growing in us a social consciousness which has become more impelling than our legal obligation. We had come to realize that, in the words of an early *Account-*

ing Research Bulletin of the American Institute of Accountants:

> "The test of the corporate system and the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not from that of any one group of interested parties."

But if the results are to be judged in a test of the corporate system then there must be a common ground of understanding between the results and the judges. And this common ground must be achieved on trust derived from honest reporting effectively presented. More of the people are forming opinions on things economic and political and they have to have more information in more understandable form if the opinions are to be well founded. And unless the opinions are reasonably well founded we shall suffer the consequences; for it is the essence of our particular form of government that, right or wrong, the will of the majority shall prevail.

If, therefore, we not only tell the accounting truth, *but tell it well,* we shall be laying the sound foundation for that further evolutionary progress which, in our happy form of disturbed society, can come only with the consent of self-governing people learning to govern themselves by learning to think for themselves.

Comments On Current Practice

By Clem L. King, C.A.,
Secretary and Director of Research
The Dominion Association of Chartered Accountants

Ed's note:

From time to time it is our intention to publish notes prepared by Clem L. King, C.A., in his capacity as Director of Research of the Dominion Association of Chartered Accountants on various matters arousing his interest as he carries on his work. The logical outcome of these duties over a lengthy period will be the issuance of pronouncements by the Accounting and Auditing Research Committee. Before this final stage is reached, however, it would seem useful to throw open Mr. King's thoughts for public review. It is emphasized that these notes are not to be considered as pronouncements or official releases of the Association or of a Committee of the Association. Mr. King hopes that these periodic, and perhaps spasmodic, invitations will be accepted by many readers and that they will put forward their views as informally as he has put forward his. The replies received will not necessarily be published and in any event no reply will be published without preliminary discussion with the writer.

RESERVES

ONE of the hardest working terms in the accountants' vocabulary is "reserve". It is used most commonly to denote asset valuation accounts such as bad debt and depreciation provisions, actual and contingent liability accounts such as income taxes payable, and segregations of surplus such as general contingency reserves or fire insurance reserves.

A glance at the Oxford Dictionary shows that the noun means "that which is reserved; an extra supply; something kept back or withheld," and the verb means "to keep in store—to keep back, to retain or hold over to a future time or place."

Fortunately in some respects, and unfortunately in others, the accountant utilizes as part of his technical vocabulary terms which are in everyday use and he has not developed a separate terminology for his own particular field. While another accountant may recognize the particular shade of meaning in any given case, the non-professionally trained individual will take the term in its generally accepted sense. This situation has its confusing aspects when several people are discussing the use of a particular term, each placing upon it a somewhat different

interpretation. When the "man-in-the-street" uses the term "reserve" he attaches to it its generally accepted, in the dictionary sense, meaning of "something kept back or withheld; an extra supply" and upon seeing it on a balance sheet assumes that it is a fund which can be drawn upon.

Where "reserve" is used to designate an asset valuation account such as bad debts provided for or estimated depreciation, or a liability account such as income taxes payable, there is no question of "an extra supply" but rather it indicates a diminution of the owners' equity. If upon the same statement there appeared a subdivision of surplus bearing the designation "reserve", the same term would be used on a single statement to describe items of contradictory effect.

Accountants generally are giving a great deal of thought to this and similar problems and a number of authors of accounting texts are urging that "reserve" be used to designate subdivisions of surplus only. The Institute of Chartered Accountants in England and Wales has recommended that "The term 'reserve' should be used to denote amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist at the date of the balance sheet."

The so-called "Reserve for Bad Debts" is in no sense a reservation of surplus but is an attempt to measure, in the light of existing knowledge of the facts, the net amount of cash that will be realized from the receivables. This measurement is also part of the process of securing a reasonably accurate measurement of the income for the period. The only portion of this amount that is in fact a segregation of surplus is that which is in excess of requirements.

It is now generally accepted that a correct measurement of income for any period cannot be made without the inclusion of a proper charge for depreciation, the amount of which for any particular period is determined by a reasoned estimation. The accumulated amounts set aside over a period of years do not represent a portion of surplus set aside but constitute the measurement of the portion of the fixed assets which has been consumed in the course of use, and the net balance remaining represents the amount to be charged to future operations.

The use of the term "reserve" in connection with the liability for taxes, particularly income taxes, undoubtedly started because of the feeling that the calculation was an estimate and subject to final determination upon assessment at a later date, strengthened of course by the original concept now discarded, that income taxes were an appropriation of profits rather than a deduction therefrom which must be taken into account before the income of a business entity could be determined. During the past few years the actual amount of the liability for Dominion taxes was dependent upon the settlement of claims in respect of standard profits, renegotiation of contracts, and other items, so that at times only a rough estimate of the eventual liability could be made at the balance sheet date. Usually the tax liability can be estimated within the bounds of reasonable accuracy.

A number of accountants have suggested other terms to replace the overworked "reserve". In respect of the asset valuation accounts "allowance" and "provision" have been named as alternatives. Opinion in this country and the United States appears to favour "allowance" while that in England favours "provision". If "allowance" were to replace "reserve" in respect of asset valuation accounts no one reading the financial statements would have any doubt as to the intent of the term and confusion would be avoided.

To designate amounts appropriated to cover liabilities whose amounts may or may not be definitely determined "provision" is suggested as being more appropriate, and certainly more readily understandable by the general public. If a concern provides for an estimated liability elementary logic indicates that the amount so set aside should be termed a "provision". In any event any such term should be used only in those cases where the nature and/or the amount of the liability are not determinable at the balance sheet date within the bounds of material accuracy.

In respect of the liability of Income and Excess Profits Taxes payable the use of "reserve" to indicate that the figure is an estimate is of doubtful validity. If the amount cannot, for one reason or another, be estimated closely, the word "estimated" would be more descriptive of the situation, or perhaps an explanatory note would be appropriate. Such taxes are usually not payable until some

time after the balance sheet date so that if the term "Dominion and/or Provincial Income (and Excess Profits) Taxes" is not thought to be sufficiently descriptive, and it is difficult to see why it is not, then the title "Accrued" could be added. This latter title is more accurately descriptive than reserve. Now that the uncertainties of war-time taxation have disappeared, the tax due can be estimated, in most instances, with such a degree of accuracy that the figure is materially correct.

Canadian practice, as indicated by a review of a group of statements issued during the past six months, is moving towards the elimination of the term "reserve" in respect of items other than subdivisions of surplus. This trend is most noticeable in the case of the estimated liability for Income and Excess Profits taxes. On the statements reviewed the estimated tax liability was included among the current liabilities in 97% of the cases. In 56% of the cases the figure was not described as a reserve, while in 41% it was so described. The trend in the case of bad debts and depreciation is not so apparent but even here 10% of the statements used some other term in connection with the estimated bad debts allowance and 5% in connection with the depreciation allowance.

On the statements reviewed there were 340 items bearing the designation "reserve". An analysis of these items shows the wide range which the term is supposed to cover under its present usage.

*87 items—Reserve for depreciation and depletion
*71 " —Reserve for bad debts
41 " —Reserve for Income and Excess Profits taxes
40 " —Inventory reserve
29 " —Reserve for contingencies
*20 " —Reserve for losses on investments
10 " —General reserve
10 " —Insurance reserve
10 " —Reserve for employee benefits
4 " —Reserve for repairs
4 " —Reserve for uncompleted contracts
3 " —Reserve for redemption of bonds or shares
2 " —Operating reserve
2 " —Accident reserve

1 item —Reserve for dividend of foreign subsidiary
1 " —Reserve for valuation of assets on consolidation
1 " —Reserve for conversion of foreign currency
1 " —Claims reserve
1 " —Reserve for return of containers
1 " —Reserve for inventories, bad debts and contingencies
1 " —Surplus reserve.

*In a number of instances the amount of the "reserve" was not stated but a notation to the effect that such had been deducted in arriving at the figure shown appeared on the balance sheet.

In many instances, other than the first four, it was difficult to determine whether the items had been provided to meet liabilities, either actual or contingent, or whether they were subdivisions of surplus resulting from management policy decisions.

Mr. K. LeM. Carter summed up the problem as follows in his address on "Surplus and Reserve Accounts" given at the 1946 annual meeting of the Dominion Association of Chartered Accountants and published in the February 1947 issue of the Canadian Chartered Accountant:

> "It would appear to be ironical for an accountant to spend time making careful valuation of the current assets of a business . . . . and then to permit a contingency reserve to stand between the stated liabilities and the capital without a clear statement as to whether part or all of his account represented a debt or provision for the reduction of an asset. Frequently these reserves are set aside against nebulous liabilities which the management wish to avoid describing. If the net worth of the company is worth reflecting on a balance sheet, the management and its accountants must come to a conclusion and indicate whether or not such reserves are debts or represent part of net worth."

A different placement of these items on the balance sheet would sometimes simplify the problem of the reader in determining whether or not the items constitute a division of surplus, but a more descriptive and less confusing terminology would be a major step in the right direction.

The Profession of Chartered Accountancy

By C. A. Patterson, F.C.A.

Background of the Profession

I RECENTLY read an article which appeared in an accounting publication some years ago which referred to the professional status of accountancy and had this to say about a profession—

> "A profession is accorded a privileged status by society because society is compelled to depend upon it and to put faith in its ability to perform its services skilfully and honourably. The privileged status and the faith accorded it impose upon the members of the profession obligations different from those of other callings, and upon the profession as a whole a responsibility devolves to see that those obligations are not evaded by its members."

I believe that the background and development of chartered accountancy and its present-day standing in society clearly classifies it as a profession.

The development of the profession of accounting and auditing is perhaps a fairly recent one, compared with other professions such as the law or medicine, if it is dated from the time its practitioners first organized themselves and obtained legislative sanction for their associations. In Great Britain, where auditing made an early appearance, it was not until the middle of the nineteenth century that this movement toward professional status was begun.

However, bookkeeping, along basically the same scientific principles as are practised today, was understood and used about the time of Columbus, and in the fourteenth, fifteenth and sixteenth centuries we find men being designated as auditors, to check the accountability of public officers and tax collectors for revenues collected. The large manor houses, which were the big businesses of those times, employed full-time auditors to verify receipts and disbursements and present a summary of them to the lord of the manor.

The change in the economic life of Great Britain in the seventeenth and eighteenth centuries was responsible for the emergence of the accountant as the skilled expert who was more than a bookkeeper, or a person employed to check

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An address delivered to the Institute of Internal Auditors Inc., Toronto Chapter, January 31, 1947.

on the honesty of someone else and who now was concerned with the financial position of commercial enterprises. There were not yet, however, independent accountants who offered their services to whomsoever might require them. Men who were expert in accounting worked for one employer and if their knowledge was utilized by others, this work was done apart from their regular employment. In addition, the solicitors of the period did much of the work that would today be performed by the accountant; e.g.—the preparation of statements required by bankruptcies and executorships. In fact, after the accountants in Scotland organized their own society in 1854, many of the members were also solicitors. In this transitional period, there were many who advertised themselves as accountants, combining this occupation with other varied ones, such as brokers, appraisers, auctioneers, writing masters and even one who was a dealer in tin plate. But from the end of the eighteenth century onward, the number of persons who held themselves out to be accountants, and that alone, steadily increased until in 1845 it is noted, from old directories, that there were 210 accountants in public practice in London. At that time, however, there was not yet an organized society with admission requirements and standards such as have been further developed until the present time.

Great Britain

The accountants in Scotland were the first to seek statutory recognition of their profession with the application of an association of accountants in Edinburgh (formed in 1853) for a charter of incorporation, which was granted in 1854. This charter stated that the duties of an accountant in Scotland required "great experience in business, very considerable knowledge of the law and other qualifications which can only be attained by a liberal education", and the society was empowered to hold examinations and prescribe courses of training for entrants. This was the beginning of the use of the title "Chartered Accountant", which was applied to members of this first society. A similar association in Glasgow, formed also in 1853, although later in the year than the Edinburgh society, was granted a charter of incorporation in 1855, and it also used the title of "Chartered Accountant". A third society was incorporated in Aberdeen in 1867.

The emergence of the profession in England, as such, was only slightly later, and it is interesting to note that this development was influenced by the Companies Act of 1862 and the Bankruptcy Act of 1869. The Bankruptcy Act abolished the Official Receiver and provided for the appointment of receivers by the creditors, who generally appointed an accountant. The Companies Act created a demand for professional accountants to act as auditors and liquidators, although it was not until 1900 that every company was obliged to have an auditor elected by the shareholders. In 1870, the accountants in Liverpool organized themselves into a society, and similar associations in the larger centres followed, but the regulation of the profession by charter was not obtained until 1880, when five English societies formed themselves into the "Institute of Chartered Accountants in England and Wales", with "Fundamental Rules" of conduct and wide powers of expulsion. In addition, there were qualifications of entry, modelled on those governing admission to the roll of solicitors, and the members readily adopted the title "Chartered Accountant" as used by the Scottish accountants. To complete the picture, the Institute of Chartered Accountants in Ireland was incorporated in 1888.

It is not necessary to describe, except very briefly, the formation of other societies in England which followed the incorporation of the original one. In Scotland, there was no such development, but in England various other groups have sought, and obtained, recognition by incorporation, at least one of which, the "Society of Incorporated Accountants and Auditors", ranks alongside the original "Institute of Chartered Accountants in England and Wales". Other smaller societies have been formed, representing a special type of employment or a special application of technique, such as the "London Association of Accountants", the "Corporation of Accountants", and the "Institute of Company Accountants", but their history is not germane to our present subject. Mention of them is made only to show the desire of the accountant, of varying professional grades, to regulate and improve his profession by forming associations for this purpose. In bringing to a close this brief story of the development of the profession in Great Britain, before speaking of its position in the United States and Canada,

mention might be made of the effort that is now being made in England to unite the few smaller societies and the two larger ones into one large controlling or regulatory affiliation, which is another illustration of the desire of public accountants still further to advance the profession for the mutual benefit of the public and the practising members.

United States

The earliest evidence of professional consciousness among the accountants in the United States became apparent when the American Association of Public Accountants was formed in December 1887. About that time, or shortly after, foreign capital flowed into the United States and with it came many accountants from Great Britain to examine and report on the financial position of businesses. Bankers and businessmen became aware that Great Britain had professionally trained men—chartered accountants—who were skilled in accounting and auditing; these had integrity and broad knowledge of business affairs, and their services were used by investors, granters of credit and others to gain independent opinions of financial conditions, results from operations, and to determine whether investments or loans would be justified or should be continued.

While these accountants wished formal recognition of their status by the States, it was not until 1896 (at which time there were a large number of practising accountants) that a Bill sponsored by the Association became law in New York State which authorized the use of the title "Certified Public Accountant", and restricted its use and the initials "C.P.A." Other States followed in adopting similar legislation from 1899 to 1908 and continued thereafter until the early 1920's.

The American Association of Public Accountants, which had been formed in 1887, in 1905 reorganized and absorbed "The Federation of States Societies" which had been formed in 1902: this Federation had no direct control over membership in the various States Societies and acted only through those State organizations. Again this Association was reorganized in 1916 as "The American Institute of Accountants". As late as 1921 there were two national professional organizations in the United States—

"The American Institute of Accountants" which had been making strenuous efforts to establish a reputation for members and improve the profession; and

"The American Society of Certified Public Accountants" which had for its aim the protection of state-granted titles.

These two organizations were merged in 1936 as "The American Institute of Accountants" which is now the well-known and important national organization of certified public accountants in the United States. This Institute now has a membership of over 10,000 members. The State Societies, which have well organized programs for the development of the profession and co-operate closely with the national organization, have a membership of over 16,000 certified public accountants who are not members of the A.I.A.; overall, there are approximately 26,000 certified public accountants in the United States. They are organized in professional Societies, both National and State, which have rules of professional ethics rigidly enforced and which play an important part in the improvement of professional procedures and the development of objective standards in accounting and auditing. The profession is represented by these organizations which now enjoy, in large measure, public recognition as a profession of character and attainment. This is due largely to the work of these organizations in representing the certified public accountants before legislative bodies, government agencies, stock exchanges, organizations of bankers and credit men, bar associations and the business, financial and trade groups generally.

In the United States, the degree of "C.P.A." is granted by the States after an applicant successfully complies with certain requirements and has met certain standards of theoretical and practical proficiency. Each State has its own laws governing the issuance of this certificate or degree and the laws of the various States differ somewhat as to academic and experience requirements, but in every instance they restrict the issuance of certificates to those who have successfully completed a written examination. In this respect a great deal has been accomplished by the American Institute of Accountants which developed uniform examinations and offered them to the State Boards. This proved a very successful development and there are 44 States and territories which use the Institute's uniform examination problems to test the proficiency of applicants for the degree.

The granting of degrees by the individual States differs from the practice followed in Great Britain and Canada where the degree is granted by the chartered accountant institutes—in fact, British and Canadian chartered accountants obtain their formal status only through the exclusive charters of their various institutes.

Canada

The formal history of the profession of the public accountant in Canada is notable for the fact that the first charter to an association of accountants in Canada was granted in 1880—the same year that a charter was given to the first English accountants. The reason for this may lie in the fact that the Scottish accountants had formed their first association twenty-six years earlier, and the development of the profession in Canada was very much influenced by Scottish accountants who came to this country as settlers. This first group in Canada was composed of English and French-speaking accountants in practice in Montreal who applied for a charter from the Quebec government, and were known as "The Association of Accountants in Montreal". Their association had as its stated objects—

> "To promote the efficiency and usefulness of its members and to afford opportunity for giving expression to their opinions upon all questions bearing upon or affecting their calling",

and they proceeded to designate themselves as "Chartered Accountants", following the Scottish practice. Later the name of the Association was changed to "The Society of Chartered Accountants of the Province of Quebec", and in April 1946 it became known as "The Institute of Chartered Accountants of Quebec". This last change was made under "An Act to Regulate the Practice of Accountancy and Auditing" and at the same time the Institute was given the power to regulate and control the profession of public accounting in the Province of Quebec.

Ontario accountants closely followed their Quebec colleagues, in point of time, in forming themselves into an association. In November 1879, we find a group meeting to draw up plans for a society which was named "The Institute of Accountants and Auditors of Ontario". The objects of this association were stated to be the promotion of knowledge and the increase of skill amongst those following the calling of "accountant", by means of instruction and exam-

inations. To this society were admitted, not only accountants practising publicly, but also accountants in banks and other commercial enterprises and bookkeepers, and there were established two grades of members—those who were entitled to the use of the term "Fellow of the Chartered Accountants" (F.C.A.) upon qualifying by examination—and orindary members, who qualified only by reason of their position in the business world. However, by 1891, the necessity of having members qualify only by passing prescribed tests of knowledge and competency was recognised and the by-laws were amended to this end. While the original institute was formed in 1879, it was not until 1883 that incorporation was obtained, although it had been sought much earlier. This delay was due to the suspicion with which the legislature, which was predominantly composed of rural members, viewed this banding together of accountants.

However, on 1st February 1883, incorporation was finally obtained from the Ontario Government, under the name of "The Institute of Chartered Accountants of Ontario", the accountants having succeeded in convincing the legislators that their objects were predominantly educational and that there was no cause for alarm in the formation of this body. In 1886, a charter was granted to the Chartered Accountants Association of Manitoba, and over the period of the next thirty-five years, the other provincial institutes were formed, with Prince Edward Island completing the movement in 1921. At present there is an Institute of Chartered Accountants in each province of Canada.

The formation of the Dominion Association of Chartered Accountants came about as a result of the desire of public-spirited accountants to extend the regulation of the profession in the interests of the general public. It should be stressed that the efforts of the chartered accountant to regulate, by union, the activities of all who hold themselves out to be experts in this field have been motivated by the desire to improve the status of the profession, in the interests of the public as well as of the accountant, and not by a desire to obtain a restrictive monopoly for the selfish interests of a few. Continuing evidence of this is given by the work of committees of the Dominion Association in the fields of education and research, which will be mentioned briefly later on. [To be continued next month]

Personals

Robert W. Meanwell, Chartered Accountant, announces the opening of an office for the practice of his profession at 209 Guaranty Trust Building, Windsor, Ontario.

Campbell, Imrie & Shankland, Chartered Accountants, of Kelowna and Nelson, British Columbia, announce the opening of a branch office in the Jacques Building, Vernon, British Columbia. Clive H. Reid, Chartered Accountant, formerly of Edmonton, Alberta, is the Resident Manager.

Stanley R. Brunton, Chartered Accountant, announces that he has admitted to partnership Gordon E. Browning, Chartered Accountant, as of February, 1946, and Edward K. Brunton, Chartered Accountant as of February, 1947. The business will be carried on under the firm name of Stanley R. Brunton and Company, 67 Elm St. E., Sudbury, Ontario.

C. P. Mackintosh, Chartered Accountant, has pleasure in announcing that he has taken into partnership in his Calgary office Mr. J. G. Simonton, B.Comm., C.A.

The partnership will be carried on under the firm name of Mackintosh and Simonton, Chartered Accountants, 207 Insurance Exchange, Calgary, Alberta.

Sylvio de Courcy, Chartered Accountant, announces the removal of his office to Suite 309, St. François-Xavier Street, Montreal, P.Q.

Albert Freedman, Chartered Accountant, announces the removal of his office to The New Wellington Bldg., 137 Wellington St. West, Toronto 1, Ontario.

Messrs. Price, Waterhouse & Co., announce the opening of an office at 46 Elgin Street, Ottawa, Canada under the management of Mr. James Ross, C.A.

Provincial News

Ontario

At the annual election of Officers of the Toronto Chapter of the Institute of Internal Auditors, the following were elected:

President, George Appleton, Toronto Hydro Electric System.

Vice-president, Blake A. Cockburn, Robert Simpson Co. Ltd.

Secretary, Robert H. Wood, Lever Brothers Ltd.

Treasurer, F. Allan Douglas, McCormicks Limited.

Board of Governors, A. J. E. Child, Canada Packers Ltd.; Frank A. Riddell, George Weston Ltd.; W. J. L. Townsend, Canada Packers Ltd.; L. G. Geering, Famous Players Canadian Corp.; D. F. Bissonnette, Toronto General Trusts Corp.; J. F. Kidner, Canadian Oil Cos. Ltd.; Walter I. Markle, Underwoods Limited.

The new officers take over their duties at the September meeting.

Messrs. Cockburn, Bissonnette and Kidner are members of the Institute of Chartered Accountants of Ontario. Other members of the Institute are cordially invited to become members of this Toronto Chapter or to attend dinner meetings held at the Royal York Hotel on the last Friday of each month from September to May at 6.15 p.m.

The Council of the Institute of Chartered Accountants of Ontario announces the election of the following members as Fellows of the Institute at a meeting held on May 23rd, 1947:

B. A. Armstrong, N. W. Cleary, V. W. T. Scully, Ottawa; K. W. Dalglish, Montreal; R. G. H. Smails, Kingston; C. A. Ashley, H. E. Crate, H. O. Glover, T. A. M. Hutchison, W. L. L. McDonald, S. E. Parker, D. J. Sales, S. C. Scott, L. J. Smith, W. A. Staples, R. B. Taylor, David Vise, J. A. Wilson, J. R. M. Wilson, Toronto.

A reception for the new Fellows was held in the Institute lounge on June 25th, 1947 at which time their Fellowship certificates were presented.

Saskatchewan

The Regina Chartered Accountants' Club wound up their first season's bowling activities with a banquet and dance on May 22nd. H. A. Hunt, chairman of the bowling committee, presided at the banquet. Special guests were Mr. and Mrs. Walter Eiler who presented the club with a very excellent trophy for annual competition. Mr. Eiler presented the trophy to the winners, Geo. A. Touche & Co. Clair H. Smith, Provincial President, presented the prizes to the runners up, Goldie, Hunt & Co. Ian Forbes, a member of the bowling committee, presented the individual prizes. Individual prizes went to the folowing:

Top six averages: Doug Shaw, Austin Hunt, Bill Fowlie, Ed Mann, Ken Byrne and Victor Ursaki.
High single and cross: George Innes.
Low average: Bob Clements.
Beginners special (most games under 100): Frank Rob-[ertson.]

It was the unanimous opinion that bowling had been a most successful venture by the club and plans are being made for an additional two teams to make a total of ten for the 1947-48 season.

Obituary

The Late William Waters Holland

The Institute of Chartered Accountants of Manitoba records with regret the death of William Waters Holland at Winnipeg on May 11, 1947.

Mr. Holland was born in Brixton, England in 1869 and came to Winnipeg in 1901. He served Laing and Turner, Chartered Accountants, and was admitted to membership in the Institute in 1913. He later established his own practice which he continued until the time of his death.

Sincere sympathy is extended to his daughter.

LEGAL DECISIONS RESPECTING THE INCOME WAR TAX ACT OF CANADA

PAYMENTS TO SHAREHOLDERS

National System of Baking Limited, Appellant

— and —

The Minister of National Revenue, Respondent

(The Exchequer Court of Canada, Angers, J., 3rd April 1947)

The income tax return submitted by the appellant for the year 1940 showed the net taxable income as $4,552.74 and the appellant claimed that since this sum was less than $5,000., it was not subject to excess profits tax. During the year the National System of Baking of Alberta Limited, a shareholder of the appellant, performed services of supervision, purchasing and delivery of commodities and bookeeping for its related companies and recovered $11,549.74 of the amount expended from the appellant in accordance with the practice of previous years. The appellant regarded this as an expense in arriving at its net taxable income. The Minister disallowed this amount and claimed that the appellant was not exempt from tax under the Excess Profits Tax Act, 1940, since (a) the whole of the amount was a payment to a shareholder by way of salary, interest or otherwise within the provisions of section 7(c) of the act and (b) that portion paid to officers or employees of National System of Baking of Alberta Limited, who were shareholders of the appellant, is a payment by the appellant by way of salary, interest or otherwise and is not deductible under the provisions of section 7(c).

Held: after an elaborate review of precedents the judgment concluded with the following: "I am satisfied that the words 'or otherwise' contained in subsection (c) of section 7 of the Excess Profits Tax Act, 1940 must be interpreted strictly and that they do not apply to payments made to a shareholder as reimbursement for expenses incurred and services performed, but must be restricted to cover only salaries and interest payments, to which may presumably be added dividends since the enactment of section 7(a) by the statute 6 Geo. VI, chap. 26, assented to on August 1, 1942. I have reached the conclusion that the payments made by appellant to National System of Baking of Alberta Limited were not made by way of salary or interest. With mature deliberation I am unable to convince myself that the payments effected by appellant in the conditions disclosed by the evidence come within any of the definitions of 'salary' hereinabove quoted or referred to. Unquestionably they cannot be considered as interest payments.

I do not think that the words 'or otherwise', however general and broad they may be but vague and indefinite, can comprehend payments of the nature of those involved in the present appeal, which differ essentially from payments by way of salary or interest.

For these reasons there will be judgment in favour of the appellant maintaining its appeal, setting aside the assessment and the decision of the Minister and ordering that the sum of $409 for excess profits tax included in the notice of assessment be struck therefrom.

The appellant will be entitled to its costs against the respondent.

DEPENDENTS — ADOPTED CHILD

Henrietta A. R. Anderson, Appellant,
—and—
The Minister of National Revenue, Respondent
(The Exchequer Court of Canada, Angers, J., 20th May, 1947)

In 1932 the appellant adopted two children, aged 7 and 4 years, by verbal agreement with their parents, and undertook the sole responsibility for their care and maintenance. She maintained both children until 1940, at which time the older child returned to her parents. She continued to support the younger child. During the years 1935 to 1939 inclusive, the appellant claimed and was allowed exemption under the Income War Tax Act as an unmarried person maintaining a self-contained domestic establishment and actually supporting therein persons wholly dependent upon her and connected by blood relationship, marriage or adoption. The Minister subsequently claimed that the adoption was not one within the meaning of the relevant sections of the Act and re-assessed the appellant for the taxation years 1935 to 1939 inclusive.

HELD: After an extensive review of precedents dealing with the interpretation of statutes the judgment stated in part—

"It seems obvious to me that the position of appellant with respect to Beverley and Helen Price meets all the exigencies of clause (iii) of paragraph (c) of subsection 1 of section 5 of the Income War Tax Act, as amended by 23-24 George V, chapter 41, section 4, which was previously paragraph (f) of section 2 of chapter 97 of the Revised Statutes of Canada, 1927, and originally clause (ii) of paragraph (n) of section 2 as enacted by 16-17 George V, chapter 10, section 1. Indeed she was at all material times an individual who maintained a self-contained domestic establishment and who actually supported therein two individuals connected with her by adoption.

"I do not think that Parliament intended that the adoption ought to be made in compliance with the requirements of the various adoption acts, the main and most important objects whereof concern civil status and civil rights, which do not fall within the field of the Dominion jurisdiction but form part of the domain of the provinces. After giving full consideration to clause (iii) of paragraph (c) of subsection 1 of section 5 and the fact that the word "adoption" was inserted in the section of the statute dealing with deductions and exemptions unreservedly, I am satisfied that the legislators, who are usually accurate and precise, wanted, at a time when the exchequer was not so heavily burdened, to put on the same footing as the natural parents any individual who, maintaining a self-contained domestic establishment (otherwise residence), actually supports therein one or more persons connected with him by blood relationship, marriage or adoption.

"After a careful perusal of the appellant's testimony and of the exhaustive argument of counsel, an attentive study of the law and its numerous amendments and a review of the precedents, I have reached the conclusion that the case of the appellant comes within the ambit of clause (iii) of paragraph (c) of subsection 1 of section 5 and that she is entitled to the exemption thereby provided for and that consequently her appeal must be maintained.

"There will be judgment maintaining the appeal, setting aside the assessments for the years 1935, 1936, 1937 1938 and 1939 and the decision of the Minister and declaring that the appellant is entitled to the exemptions claimed in her notice of appeal.

"The appellant will be entitled to her costs against the respondent."

Current Accounting Literature

By Frank S. Capon, C.A.
Montreal, P.Q.

Inventory Valuation at Direct Cost

The 15th April N.A.C.A. Bulletin contains an article by C. L. Clark recommending the valuation of inventories on the basis of direct and variable cost, plus a set amount for fixed charges. This is partway between total cost and direct cost only, but a convincing case is not made for the proposal. Management may want various types of financial data, but the desirability of changing basic accounting principles to meet every whim should be questioned very seriously. Every accountant knows that statements can be prepared to show almost any predetermined result within reason, but surely it is better to adhere to generally accepted principles, and to produce reports and schedules to interpret statements for management. At the same time, the basic principles must be under constant review by accounting bodies.

Standard Costs

Although most general articles on standard costs cover substantially the same ground, few are as clearly composed as that by T. B. Noble in the 15th April N.A.C.A. Bulletin. Establishment of standards for labour and materials, based on time and motion studies, are discussed, and also the techniques of variance analyses. The article consists of a theoretical case study, and is admirably illustrated with schedules.

Cost Reduction

At a time when all industrial units are being slowed down by war-born inefficiencies, it is refreshing to read a really aggressive article on cost reduction—one which offers some constructive suggestions. The N.A.C.A. Bulletin of 1st May contains a paper by T. D. Foy, in which he claims that profits must be maintained through cost reduction rather than by price increases, and also that every employee must take a share in the process of cost reduction. Few will argue with Mr. Foy in his contention that all businesses have permitted gross extravagances to creep in during a period of record sales and high tax rates, and few will argue with his conclusions and recommendations.

Professional Etiquette

The second and concluding section of the article on professional etiquette, by R. A. Witty, appears in the May issue of "Accountancy". After dealing with the handling of clients' money, evidence in court against accountants, relationships with lawyers, basis of fees, opening new practices, and etiquette observance by industrial accountants, Mr. Witty concludes with the observation that the etiquette rules are aimed at enhancing the standing of the profession in the public eyes and that the rules are observed just as carefully by non-practising members as by the practitioners.

Modern Professional Practice

On the occasion of the introduction of the new U.K. Companies Act, the profession in Britain is reviewing many of its long-standing principles and practices. The two articles on this subject by S. R. Hogg, published in the 5th and 12th April issues of "The Accountant", discuss some of the new problems arising out of the major changes in the financial sections of the Act, and are of particular interest to Canadian accountants in view of the possibility of a complete overhaul of our legislation in the near future.

Economic Accounting

Even those of us who consider ourselves dyed-in-the-wool free enterprisers agree that Government has a right to the information necessary to carry out its policies—and in most cases we even go along with the thesis that Government, by its policies, should exercise certain overall guidance of industry and the national economy. If this is to be accomplished, vital information must be available quickly, and this is primarily an accounting problem. The two-part article by F. S. Bray in the 19th and 26th April issues of "The Accountant" discusses this problem, and at the same time goes at some length into the viewpoints of the economist and the accountant on fixed asset and depreciation accounting. The accountant is concerned with the proprietary interest, and with safeguarding the invested monetary capital, but the economist is concerned with the maintenance of the flow of goods and the protection of society's productive assets. Both viewpoints are important to every individual and Mr. Bray makes the point that ac-

countants have a real duty to provide the information needed by economists to enable Government to change policies while the changes can still be beneficial to society as a whole.

Unusual Costs and Inventory Valuation

Many articles have been written on various phases of inventory valuation, and another important contribution has been made by H. T. McAuly in the May "Journal of Accountancy". The author has discussed at some length the various problems of costing, the purposes of cost accounting, and the results that can be achieved. In particular, he argues that selling price policy must be established on the basis of cost forecasts and desired return on investment, and that reasonable costs, which are susceptible of being forecast, are proper elements in inventory values. On the other hand, abnormal costs, which cannot be forecast, and which are not expected to recur, should be charged against profits of the period in which they were incurred rather than included in inventory values at the end of the period. This argument is, of course, based on the assumption that such costs were not taken into account for the purpose of setting selling prices, and should not be allowed to distort future profits. One weakness is that selling prices are almost inevitably reached on the basis of competition and other factors rather than on cost, but any new thoughts on inventory valuation are worthy of serious consideration.

Accounting and Industrial Peace

Writing under the above title in the May issue of the "Journal of Accountancy", Mr. Victor Z. Brink has reviewed the causes of present labour troubles, the part that accounting has played in their solution, and the greater part that it can play. In the past, the accounting emphasis has been on the responsibility to shareholders, possibly causing some misunderstanding among employees and, more particularly, some misinterpretation of the share of income accruing to owners. In short-run problems, accountants must produce financial analyses and reports on which agreements must be based, but the greatest contribution remains to be made by way of clarification of accounting data and reports so that labour can gain a greater degree of confidence and understanding of the results of business.

Public Opinion on Financial Statements

A preliminary report has been issued by the Controllers Institute on its study of the public opinion of corporate annual reports and financial statements, and the report is discussed in the May issue of "The Controller". The most startling fact is that 45% of the persons interviewed believed that profits were higher than reported, regardless of the audit certificate, and 56% of the people consider reports to have too many figures and technical words. These results come from the U.S. where companies have been developing for many years the "popular" form of annual report, and there is every reason to believe that a Canadian poll would show even more unfortunate conditions. Audited financial statements are without doubt the most important documents produced by accountants, whether industrial or professional, and the Controllers Institute survey presents us with a very serious challenge.

Co-ordination of Organization

Another outstanding article on the task of the controller, as chief financial officer, in the development and coordination of an industrial organization is included in the May issue of "The Controller". W. M. Padgett, the author, points out that by the very nature of his work, the financial official has a broader overall knowledge of the Company's undertakings, as each transaction must result in an accounting entry, and he is, therefore, in the best position to build up and co-ordinate an organization. The basic rules of policy formulation, organization structure, and supervision, are also reviewed in this very complete article.

Internal Auditing

Four articles on the general subject of internal auditing are included in the March issue of "The Internal Auditor". The first, by J. M. Clapp, explains how important it is to the internal auditor to sell his job through more effective writing and speaking. Next, M. R. Jerome discusses the value of test checking in internal auditing and the extent to which this device may be safely employed, followed by a review of the relationship of internal auditors with sales departments, by E. Taylor. Finally, A. H. Kent has presented a fairly thorough article on selection and development of internal audit staff.

STUDENTS' DEPARTMENT

J. E. SMYTH, Editor

NOTES AND COMMENT

For those of our readers who are interested in the form of consolidated statements, we draw attention to the auditor's report attached to the recently published financial statements of a Canadian company. The report is qualified by a separate paragraph which reads in part, "There is recorded in the property account on the consolidated balance sheet and per contra stated as capital surplus, an amount .... which represents the surpluses of subsidiaries as at the date of acquisition of their capital . . ."

We are not familiar with the technique by which the surplus of subsidiaries at the date of their acquisition is preserved for posterity as a separate item on future consolidated balance sheets. If we interpret the auditor's comments properly, then on the working sheets in preparation of the consolidated statements an entry has been made,

Dr. Property account
Cr. Capital surplus

for the amount of the earned surplus of subsidiaries at the date of their acquisition.

The usual consolidating technique is of course to substitute the assets and liabilities of a subsidiary (offset by minority interests) for the cost to the parent company of the investment in the subsidiary. The excess or deficiency should then emerge on the consolidated balance sheet either as a residual credit or debit, respectively.

Sometimes there is not even evidence of this residual amount as a separate item on published consolidated statements, and this is so for the statements in question, but the directors in this case are good enough to tell us that "the properties . . . are included at cost to the subsidiary companies . . . plus the excess of the cost of acquiring the shares of such companies over the net book values of such shares at date of acquisition". And so "goodwill of consolidation" is here included in the valuation of "property".

Perhaps from this point on the reader can best share our problem by considering it in abstract terms:

Balance Sheet—Holding Company
(at date of acquiring subsidiary)

Investment in wholly-owned subsidiary (at cost)	$240	Share Capital	$240
	$240		$240

Balance Sheet—Subsidiary Company
(at date of acquisition)

Property	$200	Share capital	$150
		Earned surplus	50
	$200		$200

Then, in the ordinary course of events we should expect,

Consolidated Balance Sheet

Property	$200	Share capital	$240
Goodwill of consolidation	40		
	$240		$240

But here, by including goodwill of consolidation in property and showing as capital surplus the earned surplus of the subsidiary at the date of its acquisition, we appear to have,

Consolidated Balance Sheet

Property	290	Share capital	$240
		Capital surplus	50
	$290		$290

We are in agreement with the auditors that the attention of readers of financial statements should be especially directed to the nature of an accounting treatment as unusual as this.

Student's Association News

The Annual Meeting of The Chartered Accountants Students' Society of the Province of Quebec was held on Tuesday, May 27, 1947, and the following slate of officers and committee members was elected for the 1947/48 season.

President .... Emory Grearson, C.A.
Vice-President .... R. R. Pouliot, C.A.
Vice-President .... R. C. Berry, C.A.
Treasurer .... E. A. Lemieux, C.A.
Secretary .... Cecil Vineberg, C.A.

COMMITTEE

G. G. Bernard, C.A.	W. P. Gould
R. G. Buckingham	A. G. Hall
Roméo Carle, C.A.	J. P. Latendresse
Hervé Forget	John McLaughlin
Peter Greenwood	R. H. Stevenson

Also appointed were three Honorary Presidents:

F. E. H. Gates, C.A.
A.-Emile Beauvais, C.A.
A. H. Wait, C.A.

Mr. Wait, the retiring president, presented his report which showed a very active year, including four dinner meetings at which prominent members of the legal and accounting profession presented papers, a series of twenty-two lectures and study periods for English and French-speaking students, a golf and tennis field day and a supper dance.

Mr. Grearson mentioned on assuming the chair, that with so many new council members this year there would likely be a new approach to the Society's activities which augured well for a successful session.

PROBLEMS AND SOLUTIONS

THE PROVINCIAL INSTITUTES OF CHARTERED ACCOUNTANTS

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM I

INTERMEDIATE EXAMINATION, DECEMBER 1946

Accounting I, Question 3 (10 marks)

(a) What are the advantages of maintaining perpetual inventory records?

(b) Is the taking of a physical inventory necessary where such a system is maintained? If so, how are the two kept in accord?

SOLUTION

(a) The advantages of maintaining perpetual inventory records are:

1. Financial statements may be prepared monthly or oftener without the necessity of taking a physical inventory.
2. A detailed record is maintained of each item in the Inventory, whereby any discrepancy in the physical count can be disclosed.
3. Stock records greatly facilitate the re-ordering of goods and maintaining the adequate inventories for that particular business.

(b) Yes the taking of a physical Inventory is necessary. A complete physical Inventory should be taken at least once a year, either by parts of the stock in rotation or all at one time. It will be necessary to adjust the perpetual record to the physical count. Any major discrepancy should be investigated.

PROBLEM II

FINAL EXAMINATION, DECEMBER 1946

Accounting II, Question 7 (15 marks)

The unit cost of an article has been determined at $31.05 comprised as follows:

10 pounds of raw material at $1 per pound	$10.00
12 hours of labour at $.90 per hour	10.80
5 hours of machine time at $.75 per hour	3.75
Other manufacturing expenses	6.50
	$31.05

The machine used in the manufacture of the article cost $27,000 and at date of purchase had an estimated service life of 36,000 hours of which 18,000 hours have been used.

A recently developed high speed machine becomes available at a total cost of $50,000, with an estimated service life of 50,000 hours, which will double the output of the old machine. The labour rate on this machine will be $1.25 per hour and the labour time will be reduced to 8 hours per unit. Other manufacturing expenses will be reduced by 40% per unit. There will be a 10% saving in raw materials. The scrap value of the old machine is $1,000

Required:

Prepare a statement to show the total and per unit savings resulting from substituting the new machine for the old machine.

SOLUTION

Statement showing cost of manufacturing article using new machine compared with previous cost.

Revised Cost Using New Machine

Details	Revised Cost Per Unit	Previous Cost Per Unit	Saving Per Unit
(1) Raw material (details below)	$ 9.00	$10.00	$1.00
(2) Labour "	10.00	10.80	.80
(3) Machine Time "	4.23	3.75	.48
(4) Other manufacturing expenses (details below)	3.90	6.50	2.60
	$27.13	$31.05	$3.92

Total saving from substituting the new machine is .... $\frac{18,000}{2.5}$ x $3.92 = $28,224.00

(1) 90% of $10.00
(2) 8 hrs. @ $1.25 per hour.
(3) New machine cost ....$50,000.00 = $1.00 per hr.
Add: Cost of old machine ..$27,000.00
Less: Used $\frac{18,000}{36,000}$ x $27,000.. 13,500.00

13,500.00
Less scrap value 1,000.00

Total cost to be absorbed over first 18,000 hrs. ....$12,500.00 = .69 per hr.

$1.69

Rate per hour = $1.69 per hr. for first 18,000 hrs., after which it is $1.00 per hour.
No. of hours—½ x 5 = 2.5
Cost per unit—2.5 x 1.69 4.225
(4) 60% of $6.50
NOTE: This deals with savings in costs only and does not take into account the possibility of increased profits due to increased sales as a result of increased capacity.

PROBLEM III

FINAL EXAMINATION, DECEMBER 1946

Accounting III, Question 2 (25 marks)

The A. B. Coy. Ltd. went into liquidation on 1st July 1946 and you were requested by the creditors to investigate its affairs and furnish certain information at a meeting to be held on 1st August 1946. The fiscal year of the Coy. is 30th June and your investigation discloses the following figures.

Assets

	1945	1946
Bank	$ 8,000	$ 3,000
Accounts and notes receivable	100,000	75,000
Merchandise on hand	85,000	105,000
Land, buildings and plant	200,000	285,000
Goodwill	40,000	40,000
Deficit	......	40,000
	$433,000	$548,000

Liabilities

	1945	1946
Accounts and bills payable	$120,000	$240,000
Accrued wages and taxes	2,000	3,000
Loan	30,000	40,000
Mortgage on real estate	40,000	40,000
Capital	225,000	225,000
Surplus	16,000	......
	$433,000	$548,000

You obtain the following additional information:

Accounts and notes receivable are considered 70% good and 20% doubtful. $10,000 of the good accounts receivable are assigned as security against an accounts payable of $12,000.

Merchandise on hand is estimated to realize $80,000 and the land, buildings and plant $175,000.

There is a lien of $30,000 on new machinery purchased, the liability for which is included in accounts payable.

Estimated liquidation expenses $3,000.

Required:

(1) The statement or statements which you would submit to the meeting of creditors.

(2) Your comments on what you consider were the causes of the liquidation with explanatory statement.

SOLUTION

(1) **A. B. Company Ltd.**

Statement of Affairs 1st July, 1946

ASSETS

Book Value				*Expected to realize*	*Shrinkage*
	Partly Pledged Assets				
$ 75,000	Accounts and notes receivable				
	Good	$52,500	$52,500		
	Doubtful (50% good)	15,000	7,500		
	Bad	7,500	......		
		$75,000	$60,000		
	Less Assigned per contra ...		10,000	$ 50,000	$ 15,000
285,000	Land, buildings & plant		$175,000		
	Less Mortgage per contra ...	$40,000			
	Lien per contra	30,000	70,000	105,000	110,000
	Free Assets				
3,000	Bank			3,000	
105,000	Merchandise on hand			80,000	25,000
40,000	Goodwill			......	40,000
40,000	Deficit			......	40,000
$548,000				$238,000	$230,000
	Deduct				
	Preferred claims				
	Wages and taxes ......$		3,000		
	Liquidation expenses .		3,000	6,000	
	Available for creditors being 96.66c. in $			$232,000	

LIABILITIES

Book Value				*Expected to rank*
$ 3,000	Accrued Wages and taxes			—
$ 3,000	Accrued Wages and taxes			
	Fully secured			
40,000	Mortgage on real estate per contra		$ 40,000	
	Partly secured			
240,000	Accounts and bills payable ...		$240,000	
	Less Accounts payable secured by accounts rec. per contra	$10,000		
	Liens on plant per contra.	30,000	40,000	$200,000
	Unsecured			
40,000	Loan			40,000
225,000	Capital			—
$548,000				$240,000

Deficiency Account

Shrinkage per Statement of Affairs	$230,000	
Liquidation expense	3,000	
Capital		$225,000
Deficiency		8,000
	$233,000	$233,000

(2)

	1945	1946	Increase *Decrease*
Bank	$ 8,000	$ 3,000	$ *5,000*
Accounts and notes receivable ..	100,000	75,000	*25,000*
Merchandise	85,000	105,000	20,000
	$193,000	$183,000	$ *10,000*
Accounts and bills payable	$120,000	$240,000	$120,000
Accrued wages and taxes	2,000	3,000	1,000
Loan	30,000	40,000	10,000
	$152,000	$283,000	$131,000
Working capital	$ 41,000	$*100,000*	$*141,000*
Increase in machinery			85,000
Loss for year			56,000
			$141,000

Purchase of new machinery with possible decrease in production during installation.

Financing of new machinery from current operations.